R.J.Reynolds Industries, Inc.
1977 Annual Report

R.J.Reynolds Industries, Inc.

Highlights

(Dollars in Millions Except Per Share Statistics)	1977	1976	Change
For the year ended December 31			
Net sales and revenues	$6,363.1	$5,753.6	+10.6%
Net earnings	423.5	353.2	+19.9%
Nonrecurring gain included in net earnings	55.1	—	
Net earnings per fully diluted common share	8.20	6.89	+19.0%
Nonrecurring gain included in net earnings per fully diluted common share	1.07	—	
Dividends per common share	3.33½	3.13	+ 6.5%
Net earnings as a percentage of net sales and revenues	6.7%	6.1%	
Return on average total capital	15.4%	14.9%	
Return on average common stockholders' equity	18.8%	17.5%	
Capital expenditures	$ 284.6	$ 221.7	+28.4%
At year-end			
Working capital	$1,179.6	$1,028.7	+14.7%
Book value per common share	48.97	44.55	+ 9.9%
Number of stockholders	113,827	117,421	- 3.1%
Number of employees	36,705	37,296	- 1.6%

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Cover and opposite page: R.J. Reynolds Industries now directs its worldwide operations from the new World Headquarters Building, featured on the cover and shown opposite. Completed in late 1977, the five-story, mirror-glassed structure is located in Winston-Salem, North Carolina. Its 10 acres of floor space house the staffs of R.J. Reynolds Industries, R.J. Reynolds Tobacco International, RJR Foods and RJR Archer. R.J. Reynolds Tobacco Company continues to occupy the historic Reynolds Building in downtown Winston-Salem.

Report from the Chairman and President

We are pleased to report that 1977 was another year of progress at R.J. Reynolds Industries, with strong performance in most of our businesses. Both sales and earnings reached record levels, and we continued to build a solid foundation for profitable growth across our businesses.

Sales increased 11 percent to a record $6.36 billion, and net earnings increased $70 million to $424 million, or $8.20 per fully diluted share, including a nonrecurring gain of $55 million or $1.07 per share arising out of the nationalization of our Kuwait petroleum operations. A two-month longshoremen's strike in the fourth quarter that affected our containership operations reduced net earnings by an estimated 50 cents per share.

Corporate performance benefited from two financial moves during the year. We refinanced the production payment associated with the 1976 Burmah acquisition, which lowered the Corporation's effective interest cost in 1977 and will continue to do so in 1978. We replaced the outstanding deutsche mark debt with eurodollar notes, avoiding sizable foreign currency translation losses as the U.S. dollar continued to decline against the mark through year-end.

At its October meeting, the Board of Directors voted to increase the quarterly Common Stock dividend to 87.5 cents per share, an increase of 5.5 cents over the amount paid in each of the previous four quarters, bringing the annual dividend rate to $3.50 per share. The Corporation's dividend payment has increased each year for the past 24 years, except for 1971, when dividend increases were prohibited by federal economic guidelines. Last year was the 78th consecutive year of dividend payments.

The Corporation has revised its dividend reinvestment plan and now pays for all charges associated with the purchase and sale of shares and optional cash contributions of up to $60,000 annually.

During 1977 we invested almost $300 million in capital projects. In addition, $33 million of exploration spending in our energy business was charged against earnings as it was incurred, bringing exploration and development spending to $135 million for the year. Capital spending will step up in the coming years. An estimated $1.7 billion will be spent in the 1978-80 period, with more than $600 million of it earmarked for 1978 appropriation.

Energy will continue to take high priority, with about $580 million projected for the three-year period, although these plans may change when a federal energy program is enacted. We foresee superior returns coming from our investments in the energy industry, likely starting in 1979 when production from projects begun in prior years begins to come on stream.

The 1978-80 capital budget includes $670 million for our transportation business. A substantial portion of this relates to a vessel-construction program still under evaluation and on which no final commitment has been made.

During 1977 we continued to develop the management committee created in September 1976. Joseph F. Abely Jr. joined the Corporation as executive vice president and chief financial officer, and J. Dwayne Taylor was named executive vice president for energy.

We elected five directors in the past year to fill vacancies on our board, including outside directors William S. Anderson, chairman and chief executive officer of NCR Corporation, and Margaret S. Wilson, chairman and chief executive officer of Scarbroughs Stores of Austin, Texas. Three members of the management committee — Joseph F. Abely Jr., Michael R. McEvoy and J. Dwayne Taylor — were also named to the board.

We broadened our International Advisory Board in 1977, with the addition of Peter G. Williams, chairman of Inchcape (Hong Kong) Limited, and Carlo Bombieri, retired managing director of Banca Commerciale Italiana.

Colin Stokes, chairman (left), and J. Paul Sticht, president, on a balcony at the World Headquarters Building.

Similar to most American corporations, our operations continue to be affected by government policy on many fronts.

The smoking-and-health dialogue received wide attention in January 1978 when the Department of Health, Education and Welfare announced plans for an intensive anti-smoking campaign. Many commentators focused on the issue of personal freedoms in their criticism of the proposed campaign. We believe the American people are beginning to object to what they may view as excessive intervention by government into matters of personal choice.

The situation demands further scientific investigation, and the U.S. tobacco industry continues providing substantial funds for independent research on smoking-and-health issues, as well as for basic medical research. Already the industry has invested $70 million for such research.

At this writing it is still not clear what form the federal energy program will have when it is signed into law. We believe the final program must have considerably more incentives for development of new energy supplies than the plan originally proposed, if our country's energy requirements are to be met.

R.J. Reynolds is deeply involved in petroleum exploration and development, and we are also working to produce some innovative energy sources, with most of our efforts focused in the United States. We believe in this industry because of its importance to our way of life. Our investment decisions, however, and probably those of other companies in the energy industry, will certainly be influenced by terms of the energy legislation. We would like to continue and increase our energy commitment; therefore, we sincerely hope the national energy program will encourage further investments.

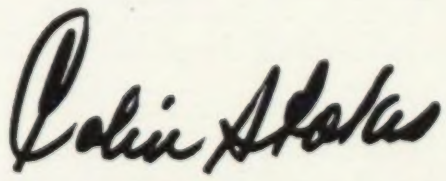
In general, we do not believe the tax proposals embodied in the Administration's economic program adequately address the structural weakness in the U.S. economy created by a lack of capital formation. In addition, the program is domestic in its orientation, with no regard for international goals. U.S. corporations have enhanced this country's presence overseas in past years, but if the role they play is to continue strong, it will have to be supported by enlightened government policy and programs.

In the shipping industry, we are beginning to see encouraging signs that the U.S. Congress may realize this country's maritime trade is in serious trouble. Federal policy has neglected our maritime industry for many years, and antiquated legislation has handicapped U.S.-flag ships in their competition with foreign fleets.

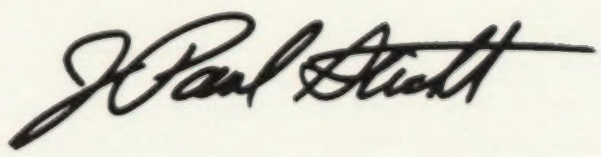
Congress now appears to perceive the threat posed to the U.S. shipping industry by foreign-flag carriers, including state-owned fleets not operated for profit. As a result, we are optimistic we will soon see legislation that will begin to better enable U.S.-flag ships to compete in foreign trade lanes. These prospects for a healthy environment for U.S.-flag carriers will play a role in our capital-spending plans.

Finally, we want to thank our fellow RJR employees around the world for helping make 1977 a year of achievement.

Respectfully submitted for the Board of Directors,



Colin Stokes
Chairman



J. Paul Sticht
President

February 16, 1978

RJR's executive vice presidents, from left (rear) J. Dwayne Taylor, J. Tylee Wilson, Joseph F. Abely Jr.; (front) Michael R. McEvoy, James R. Peterson.

Domestic Tobacco

Reynolds Tobacco continues low-tar leadership in intensely competitive year

R.J. Reynolds Tobacco Company reported record sales and earnings in 1977 and recorded a modest increase in its share of the U.S. cigarette market during an intensely competitive year. It advanced its position in the low-tar category of the market, whose exceptional growth in recent years is predicted to continue at high levels.

The company's overall unit volume increased 1.5 percent (adjusted for trading-day differences) to 199 billion units, slightly higher than the industry growth rate. RJR's low-tar unit sales rose 45 percent to 53 billion units.

Reynolds Tobacco's share-of-market grew to 33.1 percent in 1977, the third consecutive annual share-of-market increase recorded by the company. During the year, the company adopted a system developed by an outside research firm for computing its share-of-market. The new system is more timely and accurate and has changed previously reported share-of-market figures slightly. The trend, however, remains the same, showing Reynolds Tobacco increasing its share from 31.8 percent in 1974 to 33.1 percent in 1977.

The industry was flooded with low-tar brands during 1977 as tobacco companies moved to capitalize on the greatest shift in category shares since the introduction of the 100mm cigarettes in the late 1960s. More than 20 new low-tar brands or brand extensions were introduced nationally during 1977, a record high for the past decade. The industry spent about two-thirds of its advertising budget on low-tar brands.

The low-tar segment accounted for some 24 percent of the cigarette market at the end of 1977, an increase of about 40 percent over its 1976 share-of-market. Low-tar cigarettes accounted for only 10.8 percent of cigarette sales as recently as 1975. If this category grows at the rate of the filter tip category in the 1960s — and indications are that it will — low-tar brands could account for more than 40 percent of the cigarette market by 1982.

RJR's 45 percent low-tar growth during 1977 came from continued gains by Vantage, Winston Lights and Salem Lights, and the introductions of Winston Light 100's, Vantage 100's and Real.

Vantage continued as the nation's No. 1 low-tar brand, growing 21 percent and ending the year in ninth place, behind eight full-flavor leaders. Its growth benefited from the successful introduction of Vantage 100's in early 1977.

Winston Lights experienced strong growth during 1977, with an increase of more than 45 percent. The brand's high rates of growth since its 1974 introduction have made it the leader among nonmenthol light cigarettes. The successful national introduction of Winston Light 100's in March added to the overall performance of the "light" Winston products. The Winston brand family ended the year in the No. 2 position among the top-selling brands.

The company continued to grow in the menthol sector during the year, largely because of the success of Salem Lights, the nation's best-selling low-tar menthol brand. Salem Long Lights was introduced in late 1976. The two brands combined had a 2.3 percent share-of-market, outselling their closest low-tar menthol

An employee at the Whitaker Park cigarette plant in Winston-Salem works with Winstons on their way to be packaged. The company also makes several of its other brands at the modern plant on machines capable of producing more than 4,000 cigarettes per minute.

competitor by a wide margin. Their performance helped the Salem brand family strengthen its hold on fourth place among the industry leaders.

In mid-1977 the company introduced Real, a low-tar cigarette with natural flavor. Real's initial performance was affected by extraordinarily heavy competition from other new and existing low-tar brands. By year-end it established itself as a successful entry, with about a 0.5 percent share-of-market and growing unit sales.

Camel Lights — 9mg tar and 0.8mg nicotine — was introduced into test markets in the Midwest and Southwest in late 1977. Preliminary results show the brand has good potential for wider distribution. The Camel family, which includes Camel and Camel Filters, ranked No. 8 in 1977.

More — RJR's 120mm entry — continued to lead the extra-long cigarettes with 8 percent unit-sales growth, giving it a 1 percent share-of-market. More is the only 120mm cigarette with a growth trend.

NOW, the company's ultralow-tar cigarette, is firmly established, giving Reynolds Tobacco an entry in all segments of the low-tar category.

Reynolds Tobacco has long been the leader in plug chewing tobacco, with brands like Apple and Days Work, the No. 1 seller. Work Horse, RJR's entry into the growing "scrap" or "pouch" market, went on sale in several test markets towards year-end. It is believed to be the most thoroughly researched and consumer-tested chewing brand ever introduced. Its advertising stresses longer-lasting flavor and good tobacco taste. Initial consumer reaction has been positive.

In other categories, Winchester remained the best-selling little cigar and Prince Albert continued as the country's most popular smoking tobacco.

Substantial cost-savings were brought about in 1977 from an increase in manufacturing productivity of more than 9 percent.

The company is forecasting industry growth at 1 to 1.5 percent over the next few years. Most important, in the growth segment of the market — low-tar brands — Reynolds Tobacco leads the industry, with more than 40 percent of the category, and has the momentum for continued penetration as this market expands.

The controversy over smoking in public places continued during 1977. Despite evidence to the contrary, the alleged harm to nonsmokers from cigarette smoke was promoted as an issue by anti-smoking advocates.

Reynolds Tobacco, along with the entire tobacco industry, has urged a reasonable approach to smoking issues, with no restrictions unless based on fact. The company will continue to actively participate in the dialogue to keep the record straight and help avoid unreasonable restriction.

Since the smoking-and-health controversy began, the U.S. tobacco industry has invested some $70 million for independent research on smoking-and-health issues, as well as for basic medical research. This spending is close to that of all government agencies combined and significantly more than private agencies such as the American Cancer Society. Reynolds Tobacco will continue to support independent research, both on its own and with the rest of the tobacco industry.

Some of Reynolds Tobacco's leading products, including four cigarette brands in the top 10 best sellers, which help make Reynolds Tobacco the nation's industry leader.

R.J. Reynolds Tobacco Company has been making tobacco products since 1875 when Richard Joshua Reynolds founded a plug chewing tobacco company in Winston, North Carolina. Today it is the largest tobacco company in the United States, with four cigarette brands in the top 10 — Winston, Salem, Camel and Vantage. It leads the rapidly growing low-tar segment of the market with entries such as Vantage, Real and low-tar extensions of its full-flavor brands. The company offers NOW in the ultralow-tar category. Its 120mm More originated the extra-long category, which it continues to lead. In other tobacco categories, Days Work is the best-selling plug chewing tobacco; Prince Albert is the leader among smoking tobaccos; and Winchester is the leading little cigar.

Wm. D. Hobbs
Chairman and Chief Executive Officer

Morgan V. Hunter
President and Chief Operating Officer

Real
Salem
Salem Lights
Winston
Lights
NOW
More
DORAL
CAMEL
Real
Nothing Artificial Added
Salem
Menthol Fresh
FILTER CIGARETTES
VANTAGE
KING SIZE
Winston
FILTER·CIGARETTES
FULL·RICH
TOBACCO FLAVOR
Winston

Winston

International Tobacco

Tobacco International reports another year of record performance

In its second year of existence, R.J. Reynolds Tobacco International reported record sales and earnings for 1977. These increases were achieved on top of 1976 results that were substantially higher than year-earlier levels.

This performance indicates that the primary objective for the creation of a separate subsidiary to direct international tobacco operations — to focus attention on international markets — is being met.

During 1977 Tobacco International completed staffing its Winston-Salem headquarters, strengthened and standardized operating procedures throughout the company's worldwide operations and stepped up the new-product program initiated in 1976. Cost-reduction programs, initiated in 1976, were further developed in 1977 and resulted in improved profit margins in many operating units.

The company increased its position in most of its major markets during the year, with contributions both from new brands and the expansion of established brands. Unit cigarette sales increased 6 percent to 67 billion units. About 36 percent of the unit sales were exports; 58 percent were from the company's foreign manufacturing operations; and 6 percent were produced by licensees.

The company introduced 15 new products either nationally or into test markets in several countries during 1977. It currently has some 50 new-product projects under consideration and development. This program aims to establish leadership brands in every viable market segment with potential for growth.

At the beginning of 1978, Puerto Rico/Caribbean became part of Tobacco International. Previously it had been operated as a division of the domestic tobacco company. Winston is Puerto Rico's best-selling cigarette.

Unit sales in Europe/Middle East/Africa increased 12 percent to 36 billion in 1977. RJR brands increased their market share in Germany, Holland, Switzerland and France. During the year M Menthol was introduced into the German market. Time Menthol was introduced in France.

Camel made gains in the European market, particularly in Germany, where the brand was supported by the Camel Collection, a line of sportswear featuring the brand that is made by one of Germany's leading clothing companies. The promotion created a new fashion trend in Germany with its casual safari appearance. Winston remained the best-selling imported brand in the Spanish market.

Canadian unit sales were up 6 percent in 1977 as Macdonald Tobacco increased its share of the Canadian market by one share point.

Canadian performance benefited from two brands introduced in 1976 and expanded to nationwide distribution during 1977 — Vantage and Export 'A' Lights. Vantage — a Canadian version of one of RJR's top-10 U.S. brands — had 1 percent of the Canadian market. Export 'A' Lights — an extension of Canada's most popular brand — had a 2 percent share-of-market. Sales of both Vantage and 'A' Lights were continuing to increase at year-end.

Winston and Salem cigarettes being unloaded in the Philippines where the company has a licensing agreement with Fortune Tobacco Company. R.J. Reynolds Tobacco International makes its products in some 20 countries and sells them in more than 140.

R.J. Reynolds Tobacco International directs RJR's tobacco operations outside the United States from headquarters in Winston-Salem, North Carolina. The company manufactures its cigarette brands in more than 20 countries and sells them in more than 140. It employs about 7,300 persons worldwide. It manufactures cigarettes in foreign countries either at its own plants or through licensing agreements. In addition to manufacturing and marketing local brands in foreign countries, Tobacco International exports some of RJR's domestic brands.

J. Tylee Wilson
Chairman and Chief Executive Officer

G. Dee Smith
President and Chief Operating Officer

The performance of Macdonald Tobacco, like that of other large Canadian companies, has been restrained since 1975 by anti-inflation legislation, which regulates profits, prices and wages. The Canadian government has announced the phasing out of this legislation during 1978.

In Latin America unit sales fell 4 percent to 12 billion because of a program of retrenchment and product-line realignment in Brazil. During the year the operations of R.J. Reynolds Tabacos do Brasil, acquired in 1974 and 1975, continued to be restructured and consolidated. This consolidation, coupled with new operating strategies, should help improve the company's position in the rapidly growing Brazilian market, where it is the second-largest tobacco company.

During the year the company began a new-product thrust in Brazil that included the nationwide introduction of Chanceller, a full-flavor, 100mm, slim cigarette, as well as the entry of two other products into test markets. In addition to its product introductions, the company began a tobacco research program in 1977 to help it find better-yielding varieties and improve growing practices.

Vantage was successfully launched in Ecuador early in the year.

Unit sales in the Asia/Pacific region declined 10 percent to 5.1 billion units. The decline was primarily attributable to the pattern of export shipments in late 1976 and reduced sales volume in Indonesia.

Winston continued to gain in popularity in Hong Kong, where it holds the No. 2 position. Camel remained in the top 10 as RJR increased its position in the Hong Kong market during the year. Near the end of the year, a locally produced Winston was introduced in Malaysia.

In 1978 the company will step up its new-product introductions, with entries into markets with potential. To support this effort, Tobacco International will continue to work closely with Reynolds Tobacco to develop high-quality products for international markets.

Tobacco International and Reynolds Tobacco began working together in 1977 on a program to develop international marketing personnel. Under the program, trainees are hired and given marketing and sales assignments with Reynolds Tobacco. After a training period of up to two years, they are assigned to an international subsidiary.

During 1978 Tobacco International will continue a program of seminars initiated in 1977 that brings members of the Tobacco International family from around the world together to share knowledge and learn techniques developed in the United States. Seminars held during 1977 included marketing, manufacturing, quality control, personnel, finance and leaf/agronomy.

Although 1976 and 1977 were primarily years of development and foundation-building for Tobacco International, the results show impressive progress. The company expects 1978 to be another year of advance, with new-product initiatives adding to its penetration in many markets.

Some of the 65 cigarette brands R.J. Reynolds Tobacco International sells around the world, including exports of U.S. brands as well as locally manufactured products. The company is currently in the midst of an ambitious new-product program.

EUROPE
More
British
More
CAMEL
FILTER
Winston
CIGARRILLOS CON FILTRO
CAMEL
More
More
MENTHOL
Time
LUXOR
EXPORT 'A'
Lights
CHOICE QUALITY
CAMEL
LIGHT
Calver
VANTAGE
OVERSTOLZ
EXPORT 'A'
Lights
EXPORT

Transportation

Sea-Land adds final link in around-the-world service, redeploys vessels for better return

At year-end 1977 Sea-Land Service, the Corporation's containerized shipping business, added the final link to give it around-the-world service. With the sailing of the Sea-Land Commerce from Seattle to the Far East on December 25, the company began offering full container service between the U.S. West Coast and the Middle East. This service was created by the addition of sailings between the Far East and the Middle East via the Indian Ocean. Sea-Land served ports worldwide prior to the opening of the new route, but now, with the Asia/Mideast service, it literally encircles the globe.

The new service is part of a redeployment of the company's fleet that has taken vessels from some trade lanes and reassigned them to others for better profitability. This program of improved asset utilization was under way during 1977 and will continue in 1978, as a means to achieve higher returns on operating assets.

In addition to higher returns, the program aims at reducing earnings volatility. To achieve this stability of earnings, the company is aiming for realistic shares in its markets and minimum dependency on a single market area. The Atlantic service, for example, contributed to past volatility because of excessive dependence on market share. The service has been restructured using fewer ships to carry approximately the same cargo, making for better equipment utilization and improved return on assets.

The vessels taken from the Atlantic service, along with those from recently suspended U.S. domestic services, were diverted to growth opportunities. In addition to improving return on the Atlantic service, the redeployment provided vessels for growing markets in the Middle East and Latin America.

Sea-Land phased out its U.S. domestic services — Intercoastal and East Coast/Florida/Texas — at year-end because of inadequate return on assets in those trades. Sea-Land continues to provide domestic connecting service for foreign commerce via a land-transportation network between the U.S. East, Gulf and West coasts.

Service from Europe to the Middle East was initiated in late 1976 and expanded and incorporated into the Atlantic Division during 1977. At midyear the service was doubled to eight containerships and weekly sailings, and late in the year the service from the U.S. West Coast was added. Through weekly service with self-sustaining containerships, Sea-Land has become the largest regularly scheduled container carrier in the Mideast trade. This success has been supported by inland trucking and terminal joint ventures in Iran, Saudi Arabia and the United Arab Emirates.

A newly formed Sea-Land/Saudi Arabian joint venture company, Arabian Container Terminals, has signed a contract with the Saudi Port Authority naming the company as operator of a public container terminal in Dammam, Saudi Arabia. Further investment opportunities are being explored in a variety of projects now under way in the Middle East and other developing world areas.

A Sea-Land subsidiary company, Industrial Opportunity Incorporated, provides specialized transportation

A bow is ready to be lowered onto one of Sea-Land's four new D-6 containerships in Kobe, Japan. Under this construction program, four new bows, sterns and diesel power plants will be attached to the refurbished midbodies of the company's T-3 vessels.

In 1969 R.J. Reynolds acquired Sea-Land Service, the world's largest containerized shipping company. Sea-Land had pioneered the land-sea containerized freight concept, where products can be shipped door-to-door in the same sealed container by combinations of truck, train and ship. In addition to the standard 35- and 40-foot dry cargo vans, Sea-Land offers flexibility to its shippers by operating special-purpose containers to handle a wide variety of cargo, from liquids to frozen foods. Sea-Land's fleet of 58 containerships serves 136 ports in some 50 countries around the world.

Charles I. Hiltzheimer
Chairman and Chief Executive Officer

Henry L. Gilbertson
President and Chief Operating Officer

services, carrying prefabricated housing to Saudi Arabia and other countries aboard specially refitted vessels. In 1977, IOI handled the largest single contract ever awarded for the shipment of set-up housing units, transporting eight shipments of Canadian-made homes from Quebec to Arzew, Algeria.

In Latin America, Sea-Land opened several routes during the year and plans are being finalized for the start-up of container service between the United States and the east coast of South America in 1978. Pending approval from the appropriate organizations, Sea-Land proposes to inaugurate biweekly containership service to Brazil, with access to Argentina, Uruguay and Paraguay. Market research indicates potential for the growth of containerization in these countries, where existing carriers depend largely upon nonautomated methods and equipment.

Developments in Latin American markets during 1977 included:

- Weekly containership service between the U.S. East and Gulf coasts and the Caribbean islands of St. Lucia, Guadeloupe and Martinique, bringing the number of Caribbean islands served by Sea-Land to 15.
- Central American service linking the ports of Houston; Puerto Cortes, Honduras; and Santo Tomas, Guatemala. Service to key inland points in El Salvador and Honduras were also linked to the Sea-Land system.
- The opening of Sea-Land's new eight-acre container facilities at the port of Haina, Dominican Republic, to which the company provides twice-weekly sailings from U.S. ports.
- Direct containership service between Baltimore, Charleston, Jacksonville and San Juan.

The effects on profitability of Sea-Land's redeployment program began to show during 1977, although earnings were reduced by a two-month longshoremen's strike in the fourth quarter. Without the strike, 1977 would have been a good year, with earnings projected to be at a near-record level. The company believes that 1978 will be an even better year, and one in which the impact on earnings of the improved asset utilization should become increasingly evident.

In addition to diverting vessels for service in growth markets in 1977, Sea-Land began preparing for future needs with a program to update its fleet, already the most modern in the industry. During the year it contracted for a program that will create four new-technology vessels using the midbodies of its four T-3 containerships. Under the program new power plants, bows and sterns will be joined to the refurbished T-3 midbodies. When the work is completed in mid-1978, the company will have four new D-6 diesel-powered vessels with capacity of 590 containers each and two onboard cranes.

The company also took bids for the construction of five new vessels, each with about 1,100 container capacities. If it decides to build the new vessels, Sea-Land's number of ships in the new-technology category would increase to 21. The company is also considering a program similar to the one for the T-3s for its six C4J/C4JC vessels, currently in the medium-technology category.

These traditional navigating instruments, although for the most part superseded by more modern counterparts, symbolize Sea-Land's around-the-world service.

MARINER AIR PROJECTION
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Energy

Aminoil International steps up its search for new energy sources, primarily in the United States

During 1977 Aminoil International completed the shift of its development and exploration focus to the United States and intensified its search for new U.S. sources of energy. By year-end the company fully integrated into its operations the Burmah U.S. properties acquired in mid-1976; experienced the nationalization of its assets in Kuwait; witnessed the groundbreaking for an electric generating plant to be powered by dry steam from its geothermal operation in California; and began receiving gas and oil production from the Dutch North Sea and several U.S. locations.

After the first full calendar year of operating the Burmah properties — now known as Aminoil USA — the prospects for the acquired properties look even better than a conservative pre-acquisition study indicated. The properties offer substantial opportunities for profitable future investments, primarily for the development of discovered oil and gas reserves.

In addition to discovered reserves, the Burmah purchase brought Aminoil a large inventory of domestic exploration leases. During 1977 the company thoroughly reviewed these leases and has an active exploration program under way on those showing good potential.

In the United States, exploration is continuing in most major oil and gas basins, including offshore California, Louisiana and Texas; the onshore Gulf Coast; the Rocky Mountain area; off the East Coast and Alaska. Aminoil added to its U.S. exploration position by acquiring about 163,000 net acres in 1977, including seven new offshore leases.

Exploratory discoveries made in 1977 include nine new fields (four oil and five gas) offshore Louisiana, onshore Texas and Wyoming. New production came on stream from Aminoil's ventures in six new fields in offshore Louisiana, onshore Texas and Wyoming.

The company's oil- and gas-producing operations currently cover 102 fields throughout the United States. Major producing areas are in California and the Gulf of Mexico, offshore Louisiana and Texas. In California the majority of oil production comes from the Huntington Beach field, with some other oil production throughout the Los Angeles basin and the San Joaquin Valley and gas production in the Sacramento Valley.

During the year Aminoil produced an average of 42,800 net barrels of oil and condensate and 108 million net cubic feet of natural gas per day in the United States. It also produced 525,000 gallons per day of natural gas liquids and related products from 11 U.S. natural gas plants operated by the company and for the company's account from four plants operated by others.

Near the end of the third quarter, the government of Kuwait nationalized the company's assets in Kuwait and in the Divided Zone between Kuwait and Saudi Arabia. The principal assets involved were a concession in the Divided Zone, which had been producing 89,400 barrels of crude oil per day for Aminoil's account in 1977 and was scheduled to expire in 2008; and a refinery and desulfurization plant, a five-million barrel oil terminal and related facilities in Kuwait.

Two workers are surrounded by steam from one of Aminoil's 23 geothermal wells in The Geysers area north of San Francisco. Some of these wells will power a 135-megawatt electric generating station now being built by a large California public utility.

In 1970 R.J. Reynolds entered the petroleum industry by acquiring American Independent Oil Company (Aminoil), which produced oil in the Middle East. Six years later it significantly expanded its business and broadened its geographic spread by purchasing the U.S. properties of Burmah Oil. Today Aminoil International produces oil and gas in the United States and has foreign production in Iran, Argentina and the Dutch North Sea. It will produce geothermal steam starting in 1979 for an electric generating plant under construction north of San Francisco and is studying the extraction of oil from shale. In addition, it processes natural gas and markets natural gas liquids and other petroleum products in the United States. Aminoil is actively developing and exploring for energy sources in many locations, with emphasis on the United States.

J.B. Sunderland
Chairman and Chief Executive Officer

George E. Trimble
President and Chief Operating Officer

Sales of the nationalized business were $244.4 million in 1977, while earnings from operations (EFO) totaled $8.2 million. EFO had been declining in recent years, primarily because of provisions for higher royalty and tax assessments by the government.

Excluding Kuwait, foreign oil production was slightly more than 43,000 barrels per day during the year. Production from Aminoil's interest in the Iranian Consortium ran at 38,100 barrels per day. Its share in Argentina averaged 5,100 barrels per day.

Natural gas production from a joint venture in the Dutch North Sea commenced in late 1977 and will be increasing in 1978 and subsequent years. The Dutch government owns 40 percent of the project and Aminoil holds a 2.5 percent share. Although the interest is small, the reserves are large and returns from the operation are expected to be substantial.

Aminoil will step up its exploration and development efforts during 1978, with the bulk of its budget being dedicated to U.S. projects. More than $90 million is budgeted for a balanced program of onshore and offshore exploration. This represents an increase from about $30 million in 1976 and $65 million in 1977. In addition, the company intends to spend some $160 million in 1978 to bring previous oil and gas discoveries into production.

The majority of these expenditures will be for Aminoil's participation in the building and installation of 10 new drilling and production platforms to be located in the Gulf of Mexico and for the drilling of more than 200 oil and gas development wells located both onshore and offshore.

In addition to its participation in traditional petroleum sources of energy, Aminoil has become a leader in the development of geothermal steam. The use of this steam to generate electricity has the potential of becoming an important new power source in some parts of the United States.

In September, a major California public utility broke ground for an electric generating plant to be powered by dry steam from Aminoil's operation north of San Francisco. The 135-megawatt plant will be the first commerical use of steam from Aminoil's steam wells in The Geysers field. When the $60-million plant is completed in mid-1979, it will be the largest geothermal steam-powered generating facility ever constructed.

The Geysers is Aminoil's main geothermal development area. The company has already drilled 23 steam wells and has the potential for at least two additional power plants. Investment in The Geysers area is projected at some $97 million over the next five years. The company has also leased acreage in New Mexico and Nevada with a view to expanding its geothermal development.

Aminoil is also involved with oil shale technology and is a member of a project that is studying "in situ" (or in-place) extraction methods. The project is supported by the Department of Energy, which funded a substantial portion of the 1977 costs and is expected to continue funding a large share of the $9 million estimated cost of the five-year program.

During 1978 Aminoil's development spending will bring forth additional production from current reserves and the company anticipates that its exploration program will add significant new reserves.

Core samples surrounding a beaker of refined petroleum. The samples often help determine whether commercial quantities of crude oil are trapped in a reservoir.

HAWAIIAN
PUNCH
DRINK MIX
RED
PUNCH
HAWAIIAN
PUNCH
RED PUNCH
HAWAIIAN PUNCH

Foods and Beverages

Drink Mix moves into No. 2 spot as RJR Foods prepares active new-product program

RJR Foods, the Corporation's foods and beverage subsidiary, achieved record sales and earnings in 1977 as it continued to build the foundation for the high levels of growth planned in the coming years. It strengthened established product lines, introduced several new products and moved to initiate an active new-product program for future growth.

Hawaiian Punch Drink Mix continued to perform well after its exceptionally successful 1976 introduction. It outperformed all its major competitors in terms of growth and clearly established itself as the No. 2 brand nationally during the fourth quarter.

At the beginning of 1977, two new Drink Mix flavors — Lemonade Punch and Orange Punch — were introduced to accompany the original four Drink Mix flavors. The Lemonade Punch is packaged in envelopes that make two quarts of punch and in canisters making eight and 12 quarts. Orange Punch comes in two-quart envelopes and eight-quart canisters.

During the third quarter, Very Berry, Sunshine Orange and Great Grape Hawaiian Punch flavors were successfully introduced in 64-ounce resealable bottles. The three flavors joined Fruit Juicy-Red, which has been in 64-ounce bottles since mid-1976. Hawaiian Punch is now represented in flavor categories doing two-thirds of the sales volume in the rapidly growing bottled, fruit-drink market.

The Hawaiian Punch soft drink program moved forward in 1977, ending the year with 12-ounce cans of Fruit Juicy-Red available in more than half the United States. The product is marketed by more than 30 soft drink bottlers from coast to coast and sold in supermarkets, restaurants, vending machines and other soft drink outlets. Plans call for national distribution of 12-ounce Fruit Juicy-Red in 1978.

A strong showing from Hawaiian Punch helped RJR Foods to substantial growth in the Puerto Rican market. A 7.1-ounce can of Hawaiian Punch — produced solely for the Puerto Rican market — was introduced to the island during the second quarter.

At the beginning of 1978, RJR Foods began marketing seven flavors of unsweetened Hawaiian Punch Drink Mix. The unsweetened Drink Mix is sold in pouches that make two quarts of punch and will be in national distribution by spring.

With the new unsweetened powdered mix, Hawaiian Punch will be offered to consumers in five forms — liquid, frozen and shelf concentrate and both presweetened and unsweetened powdered mixes. RJR Foods is currently the only company to market a fruit drink in all five forms.

Chun King Oriental food increased its market share for the first time in several years in 1977, benefiting from product improvements and a strengthened marketing program. Chun King leads the frozen oriental food category by a wide margin and is one of the top canned oriental foods.

The company has begun to print microwave oven cooking instructions on the packages of six of its frozen Chun King entrees. Industry estimates indicate 25 percent of U.S. households — or 18 million households — will have microwave ovens by 1980, compared with 10 percent currently.

Patio frozen Mexican food main-

Packing operations for Hawaiian Punch Drink Mix. Introduced in 1976, it continued its strong performance in 1977, moving into the No. 2 spot among presweetened drink mixes.

R.J. Reynolds entered the beverage business in 1963 when it acquired the maker of Hawaiian Punch. In the following years it brought popular food brands into its family before consolidating them into a single foods and beverage subsidiary in 1967. Today RJR Foods has headquarters in Winston-Salem, North Carolina, and has 12 manufacturing plants in the United States and Canada. In addition to Hawaiian Punch, RJR Foods also produces Chun King Oriental foods, Patio frozen Mexican foods, Brer Rabbit molasses and syrup, Vermont Maid syrup, My*T*Fine puddings, Davis baking powder and College Inn products.

Robert L. Remke
Chairman and Chief Executive Officer

James H. Corrigan, Jr.
President

tained its national leadership position in the category in 1977. The frozen Mexican food category topped $83 million in 1977 and is continuing its rapid growth. New-product entries and heightened advertising will contribute to Patio's 1978 performance.

Taco Reál was introduced into test market in Houston, Oklahoma City and Sacramento in 1977. The restaurant-quality product is the first frozen taco with a crisp shell and beefy filling ever offered in supermarkets. Test-market results are positive and the company anticipates expanding Taco Reál into additional markets during 1978.

The introduction of Hawaiian Punch Drink Mix in 1976 and of Taco Reál and the Hawaiian Punch introductions in 1977 are signs of the new-product thrust that has become a central part of RJR Foods' operating strategy. This strategy calls for major new-product contributions over the next several years, along with increased penetration by current brands and external acquisitions. Several new products will join unsweetened Hawaiian Punch Drink Mix either nationally or in test market before year-end 1978.

During 1977 the foods company reorganized several functions to provide for this new-product growth. To emphasize new-product development, ongoing-product activity and new-product activity were established as separate functions in the marketing and market research departments. Two new departments were added — a sales merchandising department and a promotion development department — to support existing business as well as new business.

Last spring RJR Foods initiated a broker training program, the first of its kind ever offered by a food manufacturer. The program teaches broker sales personnel how to more effectively sell and merchandise the company's brands in retail outlets.

The foods industry is expected to be highly competitive during the next few years as producers compete for market share with both new and established entries. Certain sectors, however, will expand more rapidly than the industry as a whole, and RJR Foods is well positioned in these growth sectors for substantial future progress.

The company's major products — Hawaiian Punch, Chun King and Patio — place it in two of the three most rapidly growing food store categories — frozen foods and soft drinks. The growth of these categories stems from long-term consumer trends that should continue to show premium growth in future years.

Chun King and Patio compete in the frozen food category, which has been the No. 1 growth category in the foods industry. Both brands are also ethnic foods, which have been enjoying burgeoning popularity in recent years.

Hawaiian Punch competes in the soft drink market, the No. 3 category. The soft drink category has outstripped all other beverage categories in growth, both in terms of sales dollars and per capita consumption. This pattern of growth is expected to continue.

RJR Foods' current lines provide a solid base for future growth. The company intends to increase sales significantly through internally developed products and expects acquired product lines to add to this growth.

A product sample of the wide variety of prepared foods and beverages produced by RJR Foods. Many are sold nationwide; others regionally.

PATIO
6 Beef Enchiladas
DRINK MIX
CHUN KING
Chow Mein
CHUN KING
12 Meat & Shrimp Egg Rolls
CHUN KING
12 Meat & Shrimp Egg Rolls
CHUN KING
Shrimp Chow Mein
CHUN KING
Sweet & Sour Pork
Brer Rabbit
MOLASSES
DAVIS
Vermont Maid
My-T-Fine
INSTANT PUDDING
PUNCH
FRUIT PUNCH
RED
7 REAL FRUIT JUICES

Aluminum Products and Packaging

In its 50th year, RJR Archer narrows its focus for expansion in growth sectors

RJR Archer, the Corporation's aluminum products and packaging business, marked its 50th anniversary in 1977 with record performance, a narrowing of its operations for superior long-term growth and product-line expansions in its growth sectors.

The Packaging Division, which accounted for 48 percent of Archer's revenues in 1977, continued to provide innovative packaging materials to a variety of industrial clients and to develop new packaging applications in high-growth areas.

The division entered one of these high-growth markets during the year, when it began production of perforated tipping for low-tar and nicotine cigarettes. Archer is already considered to be a leader in supplying this material to Reynolds Tobacco and the rest of the tobacco industry. The continuing rapid growth of the low-tar category gives Archer great opportunity to expand perforated-tipping production in future years.

The division also launched a major effort to identify specific applications for its newest line of flexible packaging materials for highly active chemicals, such as iodine, alcohol and various ointments. The company's sales of drug and pharmaceutical and health care packaging are expected to rise substantially over the next five years.

Archer's pouch package for iodine and other unstable chemical solutions was presented with a Breakthrough Award by the National Flexible Packaging Association. The package offers superior protection against leakage, as well as increased packaging machine speed, compared with other packaging available for iodine. Archer also won first place in the coatings competition for the development of a flexible lidding for the Pringle's potato chip container.

In addition to its traditional packaging services to other RJR companies in 1977, Archer provided packaging materials for Reynolds Tobacco's Real and Camel Filters brands and began printing pouches for Hawaiian Punch Drink Mix as well as point-of-purchase materials for RJR Foods.

During the year the Packaging Division also developed offset labels for use on corrugated boxes, began production of a dark slide cover for instant-print photographic film, and improved its J-board, developed in 1976 for vacuum-packaged bacon.

The offset printing facility that came on line in 1976 was strengthened in 1977, helping the Packaging Division to further broaden its potential. This new installation, which includes the latest design of offset equipment available in the printing industry, enables Archer to further service both outside customers and other RJR subsidiaries with greater flexibility and more rapid response. The shorter-run capability enhances Archer's opportunity to provide packaging for new-product introductions and printed sales promotion items.

The Filmco Division — and its international operation, Filmco International — operated at full capacity at both Aurora, Ohio, and Sedgefield, England, and accounted for 16 percent of Archer's total revenues.

During the year Filmco expanded its product line with Pallet Wrap, a high-performance stretch film for containing pallet loads for shipment.

Aluminum reroll operations at RJR Archer's plant in Winston-Salem, North Carolina. Archer is one of the country's leading independent fabricators of light-gauge aluminum sheet and foil, with plants in Winston-Salem and Huntingdon, Tennessee.

RJR Archer was established 50 years ago as a department supplying "tin foil" for cigarette packaging to R.J. Reynolds Tobacco Company. Since then it has expanded its scope to include a wide range of products. In addition to furnishing wrapping materials for RJR's tobacco products, the company makes a complete range of packaging materials for many major consumer packaged goods companies. Archer is one of the nation's leading suppliers of specialty foil and sheet aluminum products, protective vinyl films and florist foil. With headquarters in Winston-Salem, North Carolina, Archer has seven plants located in North Carolina, Tennessee, Ohio and England.

Carroll G. Tompson
President and Chief Executive Officer

Outside the United States, Filmco International launched plans to broaden its base through additions to its product line as well as expansions of its facilities. The British operations have added capacity five times in the last seven years as a result of buoyant demand from the food-service and supermarket industries in Western Europe.

The Sedgefield plant is currently being expanded to allow production of biaxially oriented (two-way) PVC film for industrial use. Currently Filmco International is serving this new market with film produced in the United States at the Aurora plant.

During 1977 Archer made plans to expand outside its standard PVC product line for the first time, with the production of high-density polyethylene film. The company will first use the new product in the manufacture of plastic shopping bags to replace paper bags in food and department stores in Great Britain and Europe.

The Metals Division refined the operations of its new supercasters during 1977 and improved productivity of the continuous-cast process. The division accounted for 23 percent of Archer's 1977 sales.

The plant at Huntingdon, Tennessee, added a new oven to increase foil-annealing capacity by 50 percent, the first such expansion since the plant began operation in 1967.

In late 1977 Archer sold its Consumer Division, which made gift wrap, ribbons and bows at plants in Greeneville, Tennessee, and Carlstadt, New Jersey. It retained the division's florist foil operations and moved them to Winston-Salem.

In 1977 the Consumer Division accounted for 13 percent of Archer's sales. With the Consumer Division eliminated, the distribution of sales was: Packaging Division - 55 percent; Filmco Division - 18 percent; Metals Division - 27 percent.

Archer had originally entered the gift wrap business to utilize excess printing and foil capacity. Because of the continued growth of the company's other divisions in recent years, this excess capacity no longer existed.

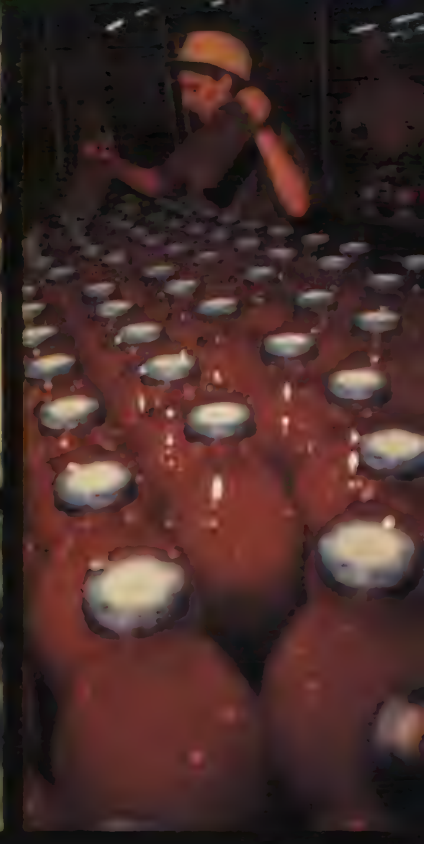
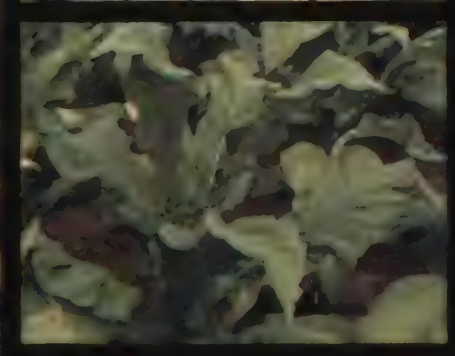
The sale was in line with Archer's strategy to concentrate activities on industry sectors where the company has the greatest opportunity for long-term growth. This strategy aims at establishing leadership positions in selected areas of the packaging and aluminum industries.

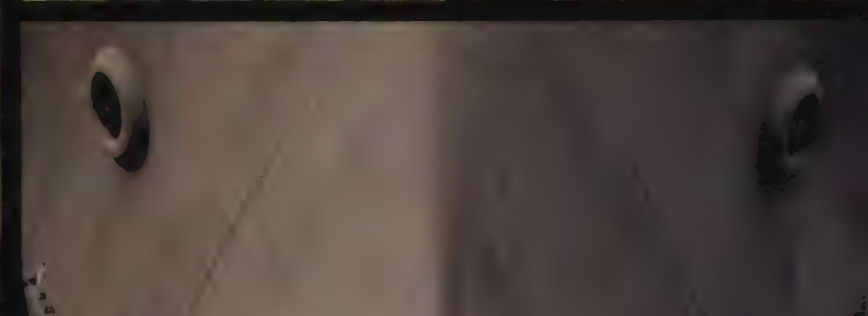
Archer has already established itself as a leader in several categories. The Packaging Division has become the fourth-largest producer of flexible and semirigid packaging materials. Filmco is the third-largest manufacturer of PVC films in the United States and Filmco International is the top producer in England, and the Metals Division is recognized as the leader in the application of continuous-strip-casting technology.

From these positions of leadership, Archer will stress performance in the areas where it can use its expertise to greatest advantage. The company expects substantial expansion of its sales volumes over the next five years from plant expansions and new products and product lines.

Some of the packaging materials RJR Archer produces for other RJR subsidiaries as well as many outside customers.

Winston



Winston

Our Fellow Employees

You are this Company's greatest strength and most valued asset. Our products and services succeed in the marketplace because of your faithful labor and cooperative spirit.

Through the years, the R.J. Reynolds Tobacco Company motto has affirmed:

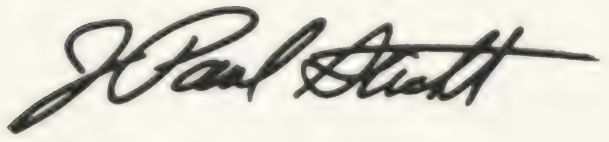
We believe in ourselves and
in our fellow employees

We believe in our Company
and its products

Their good name is our good name

While the Company has grown and diversified, we continue to recognize the importance of the men and women working together as RJR employees. The people and scenes shown on the opposite page symbolize the efforts that produced this past year's accomplishments.

Thank you for your contribution. We look forward with confidence to the future, working together.



Financial Review
Financial Review
Financial Review

R.J.Reynolds Industries, Inc.

Five-Year Consolidated Statements of Earnings

For the Years Ended December 31 *(Dollars in Millions Except Per Share Statistics)*

	1977	1976	1975	1974	1973
Net sales and revenues	**$6,363.1**	$5,753.6	$4,837.6	$4,500.9	$3,294.9
Costs and expenses:					
Cost of products sold and operating expenses	**4,773.4**	4,304.1	3,563.3	3,366.6	2,443.9
Selling, advertising, administrative and general expenses	**775.7**	669.9	563.1	476.5	357.1
Earnings from operations	**814.0**	779.6	711.2	657.8	493.9
Interest and debt expense	**(83.5)**	(70.4)	(55.9)	(59.1)	(41.6)
Other income (expense), net	**16.3**	7.6	13.7	14.3	8.6
	746.8	716.8	669.0	613.0	460.9
Foreign currency gains (losses)	**(11.7)**	(26.9)	15.3	(28.1)	(28.9)
Nonrecurring gain	**55.1**	—	—	—	—
Earnings before provision for income taxes	**790.2**	689.9	684.3	584.9	432.0
Provision for income taxes	**366.7**	336.7	346.6	287.8	186.4
Net earnings	**423.5**	353.2	337.7	297.1	245.6
Less preferred dividends	**7.4**	10.2	12.1	15.8	15.9
Net earnings applicable to Common Stock	**$ 416.1**	$ 343.0	$ 325.6	$ 281.3	$ 229.7
Net earnings per common share:					
Primary	**$8.72**	$7.47	$7.37	$6.67	$5.46
Fully diluted	**8.20**	6.89	6.69	5.97	4.98
Average number of common shares outstanding (in thousands):					
Primary	**47,729**	45,924	44,184	42,189	42,064
Fully diluted	**51,628**	51,289	50,473	49,765	49,321

Sales and Earnings

Consolidated net sales and revenues in 1977 were $6.36 billion, an 11 percent increase over 1976, while net earnings per fully diluted common share rose to $8.20, including a nonrecurring gain of $55 million, or $1.07 per fully diluted common share, relating to the Corporation's nationalized petroleum operations. (See Note 6 to the Financial Statements for details.) Excluding the nonrecurring gain, net earnings per fully diluted share were $7.13 compared with $6.89 in 1976. In addition, the Corporation's transportation business suffered a two-month longshoremen's strike in the fourth quarter that reduced net earnings an estimated 50 cents per fully diluted share. Earnings from operations in 1977 increased $34 million over the 1976 amount to $814 million.

Consolidated net sales and revenues for 1976 increased $916 million to $5.75 billion, or 19 percent above the prior year. Earnings from operations increased $68 million, or 9.6 percent, to $780 million in 1976. Net earnings rose by $16 million, or 4.6 percent, to $353 million, while fully diluted earnings per common share increased 20 cents to $6.89.

Over the past five years, net sales and revenues increased at an average annual compound rate of 17 percent, earnings from operations increased by 12 percent a year and net earnings grew at an average rate of 13 percent annually.

The percentage contributions of the Corporation's various lines of business to net sales and revenues and earnings from operations during the last five years were as follows:

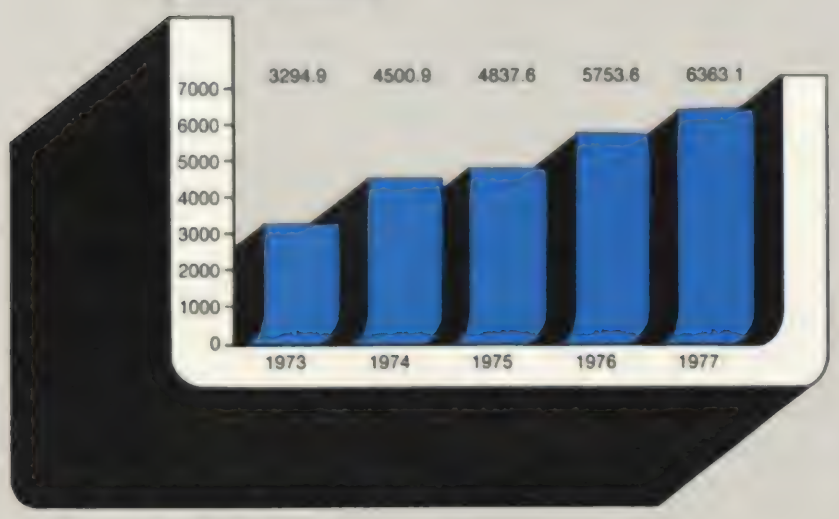
Net Sales and Revenues

	1977	1976	1975	1974	1973
Domestic tobacco	**44%**	46%	50%	48%	60%
International tobacco	**20**	19	18	16	11
Transportation	**14**	15	16	19	17
Energy	**15**	12	9	10	3
Foods and beverages	**4**	5	4	4	6
Aluminum products and packaging	**3**	3	3	3	3
	100%	100%	100%	100%	100%

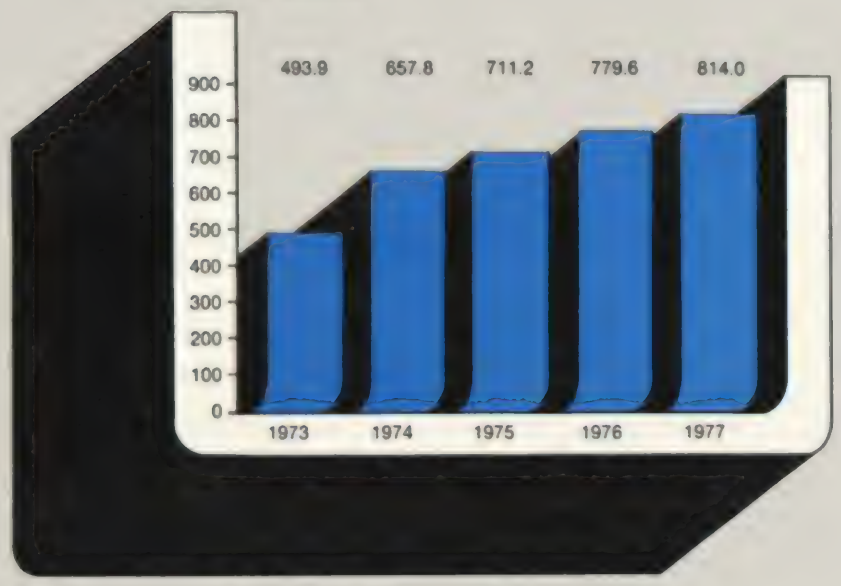
Earnings from Operations

	1977	1976	1975	1974	1973
Domestic tobacco	**73%**	69%	70%	59%	81%
International tobacco	**10**	7	4	4	7
Transportation	**10**	15	13	22	4
Energy	**2**	4	9	13	4
Foods and beverages	**3**	3	3	1	2
Aluminum products and packaging	**2**	2	1	1	2
	100%	100%	100%	100%	100%

Consolidated Net Sales and Revenues
(Dollars in Millions)



Consolidated Earnings from Operations
(Dollars in Millions)



Domestic Tobacco

Domestic tobacco operations include the manufacture and sale of tobacco products, principally cigarettes, in the United States, Puerto Rico, and export areas serviced by Puerto Rico, mainly the Caribbean. (Effective January 1, 1978, operational responsibility for Puerto Rico and related areas was transferred to international tobacco management.)

Sales in the domestic tobacco business reached $2.85 billion in 1977, a $195 million, or 7.3 percent increase over 1976. The sales gain was the result of price increases and a 1.5 percent unit volume gain. The unit volume gain was slightly ahead of the industry's performance as a whole.

Earnings from operations in 1977 rose $62 million, or 11 percent, to $618 million. This increase was due to the improved unit volume noted above and the effect of price increases, which were sufficient to offset generally higher manufacturing and advertising costs. Advertising expenditures were about $62 million above the 1976 level, mainly as a result of the introduction during the year of several new brands, most notably Real, Vantage 100's, and Winston Light 100's.

In 1976 domestic tobacco sales were up $210 million, or 8.6 percent, to $2.66 billion. The 1976 sales increase resulted from price increases in late 1975 and 1976 and higher unit volumes of newer brands. The success of new brand introductions was instrumental in the company's 2.3 percent unit sales growth in 1976, compared with an estimated unit sales gain for the industry as a whole of about 1 percent.

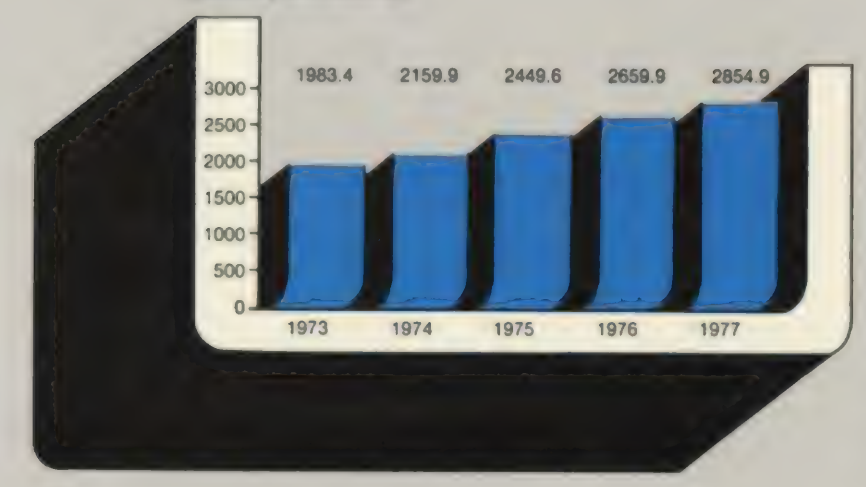
Earnings from operations increased in 1976 by 9.1 percent, or $47 million to $556 million. The higher unit sales volume and price increases were sufficient to offset significant rises in advertising and manufacturing costs. Advertising expenditures during the year were approximately $45 million above the 1975 level, largely due to the high costs incurred for new-brand introductions. A 12 percent rise in average leaf tobacco prices over 1975 was the major component in increased manufacturing costs. Under the company's LIFO method of valuing tobacco inventories, which was adopted in 1956, increased leaf tobacco costs are charged against earnings immediately and not deferred to later years, as is the case under other accounting methods.

The $8.5 million decline in earnings from operations in 1974, compared with 1973, was due primarily to significant manufacturing cost increases experienced in 1974, particularly a 23 percent rise in leaf tobacco prices during the year.

Domestic Tobacco

Sales

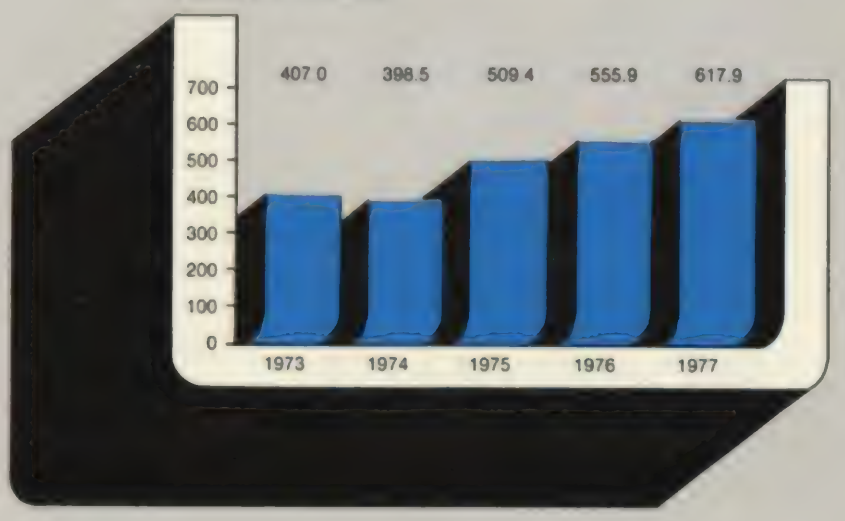
(Dollars in Millions)



Domestic Tobacco

Earnings from Operations

(Dollars in Millions)



International Tobacco

International tobacco is responsible for the manufacture and sale of tobacco products outside the United States. In 1977 cigarettes were manufactured in approximately 20 countries throughout the world by subsidiaries or licensees and sold in more than 140 countries and territories outside the United States. Such sales consist of exports from the United States and sales from the company's foreign manufacturing subsidiaries and licensees.

In 1977 international tobacco sales reached $1.26 billion, a 14 percent, or $151 million increase over 1976. Approximately one-third of the sales gain was due to higher unit volumes with increased selling prices accounting for the balance. In 1977 unit sales were up 6 percent over 1976, with both new products and the expansion of established brands accounting for the improvement. This gain reflects the company's success in its continuing effort to expand operations in the growing international tobacco market.

Earnings from operations in 1977 reached a record $82 million, up 53 percent from $54 million in 1976. Approximately half the increase resulted from the higher sales volume, with the remainder attributable to higher prices which more than offset higher operating expenses.

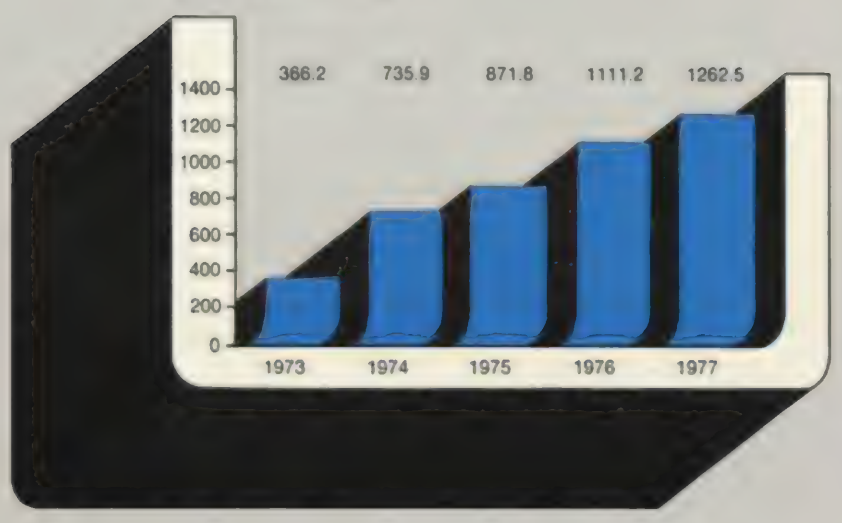
International tobacco sales in 1976 were $1.11 billion, up $239 million, or 27 percent, over 1975. Approximately half the sales gain resulted from a second Brazilian acquisition made in late 1975. The remaining increase was due about equally to higher unit volumes in other international markets and higher selling prices. Overall sales were up by 13.3 billion units in 1976. Earnings from operations in 1976 were 69 percent, or $22 million, above 1975. Volume and price increases contributed about equally to the improved results.

In 1975 international tobacco sales were $872 million, up $136 million, or 18 percent, over 1974. Approximately half the increase stemmed from a Brazilian acquisition in the fourth quarter of 1974.

Approximately two-thirds of the $370 million increase in sales during 1974 over 1973 resulted from the January 1, 1974, acquisition of Macdonald Tobacco in Canada. Earnings from operations, however, decreased $10 million, or 28 percent, during the same period, reflecting primarily costs associated with the expansion of international tobacco operations.

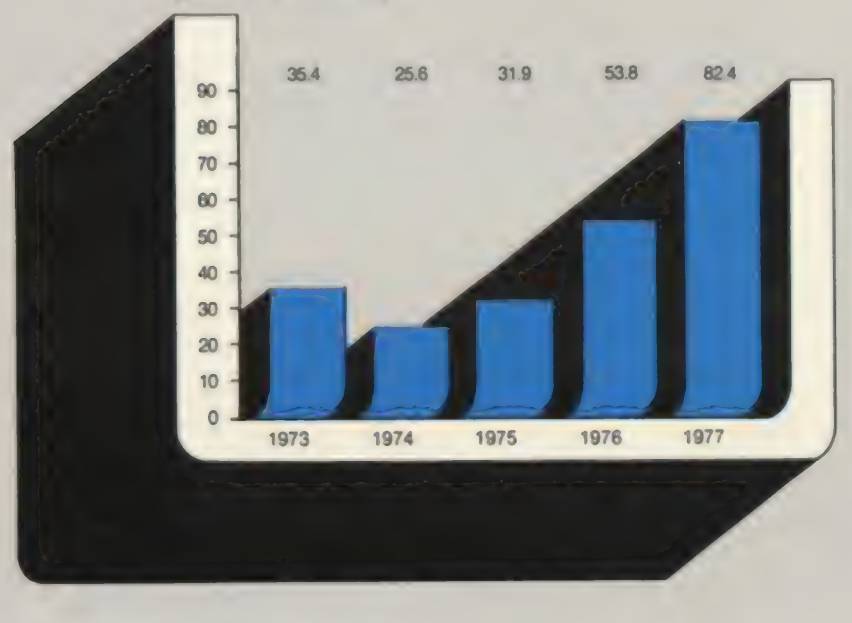
International Tobacco

Sales
(Dollars in Millions)



International Tobacco

Earnings from Operations
(Dollars in Millions)



Transportation

The Corporation operates a containerized freight transportation system through its subsidiary, Sea-Land Service, Inc. Sea-Land utilizes a fleet of specially designed containerships for ocean shipments. At year-end 1977, containership operations were provided through 136 ports in more than 50 countries.

Transportation revenues in 1977 were $873 million, up $11 million over 1976. This increase was achieved in spite of the negative effect of a longshoremen's strike (see discussion below) and resulted largely from an approximate $45 million increase in revenues attributable to the Mideast service begun in the last half of 1976 and expanded in 1977.

Earnings from operations during 1977, however, declined by 28 percent to $89 million. The decrease was due primarily to a strike by the International Longshoremen's Association, which completely stopped all containership operations on the United States East and Gulf coasts during October and November. (The Corporation estimates the effect of the strike on transportation's earnings from operations at approximately $50 million.) Higher prices for bunker fuel and increases in other vessel operating costs also contributed to the decline.

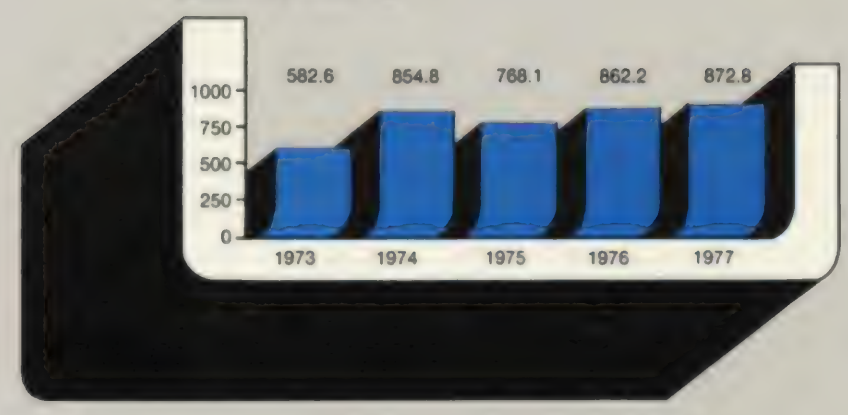
Transportation revenues were $862 million in 1976, up 12 percent from $768 million in 1975. Earnings from operations increased to $123 million, up 32 percent from a year earlier. Increased shipping volume in major trade routes accounted for approximately 85 percent of the revenue gain, with generally improved cargo mix responsible for the remainder. The improvement in earnings from operations was a direct result of the higher revenues, which more than offset increased labor costs, higher depreciation charges, and start-up costs relating to the introduction of service to the Middle East.

During 1975 transportation revenues were $768 million, a decrease of 10 percent from $855 million in 1974. Effective September 30, 1974, the company sold its Puerto Rican service to the Puerto Rico Maritime Shipping Authority. The business sold contributed approximately $85 million to 1974 transportation revenues during the nine months prior to its sale. Transportation earnings from operations in 1975 were $94 million, down $51 million, or 35 percent, from $145 million in 1974. The decrease reflected both the loss of operating earnings from the discontinued business and increased operating costs in 1975.

In 1974 transportation revenues totaled $855 million, an increase of $272 million, or 47 percent, over 1973. Earnings from operations

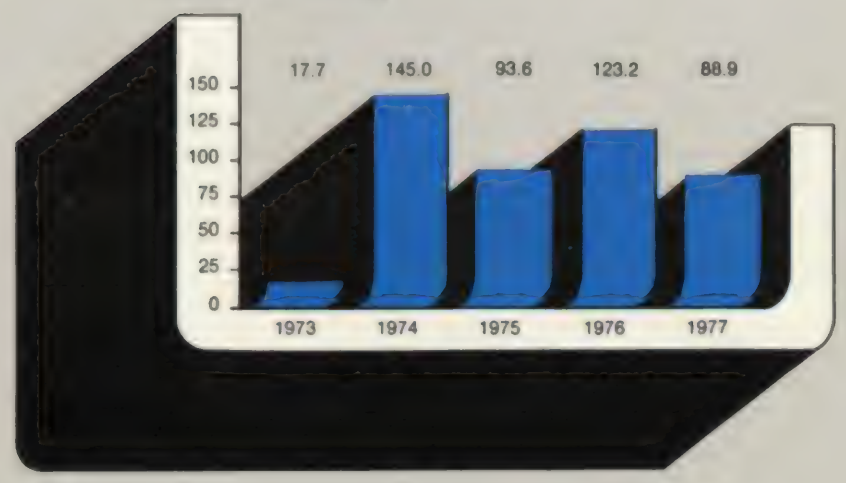
Transportation

Revenues
(Dollars in Millions)



Transportation

Earnings from Operations
(Dollars in Millions)



were $145 million, an increase of $127 million over the prior year. Approximately two-thirds of the revenue increase was due to the generally favorable world trade conditions existing in 1974 and improved rates on certain trade routes. The remainder of the increase resulted from the greater capacity of the expanded fleet. The 1974 earnings increase reflected the higher revenues, better operating performance and lower redeployment and start-up costs compared with 1973.

Energy

Operations in the Corporation's energy business are directed mainly toward the exploration for and the development, production and sale of crude oil, natural gas and other energy sources. The principal domestic producing properties are located onshore and offshore California, Louisiana and Texas. Most of the U.S. properties were acquired from the Burmah Oil Company Limited on June 30, 1976. (See Note 11 to the Financial Statements.) Internationally, the Corporation has operating interests in Iran, Argentina and the Dutch North Sea. On September 19, 1977, the Corporation's oil business in Kuwait and in the Divided Zone between Kuwait and Saudi Arabia was nationalized by the government of Kuwait. (See Note 7 to the Financial Statements.)

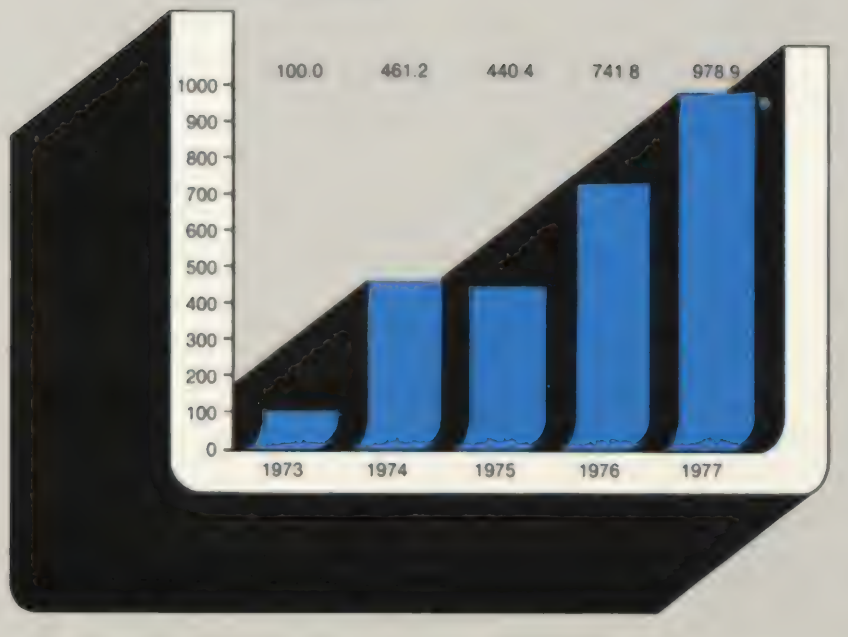
Total sales in the energy business in 1977 were $979 million, up $237 million, or 32 percent, from $742 million in 1976. The 1977 sales include the full year results of the Burmah properties acquired on June 30, 1976. This difference accounts for substantially all of the 1977 sales increase and was more than sufficient to offset the sales loss resulting from the nationalization of the Kuwait operations noted above.

Earnings from operations in 1977 were $15 million, a decrease of 60 percent from 1976. The decline resulted mainly from increased provisions for higher royalty and tax assessments relating to the Kuwait operations prior to the nationalization. In addition, current earnings continue to reflect the impact of the Corporation's vigorous exploration program for new domestic energy sources. Earnings from operations in 1977 do not include a fourth-quarter nonrecurring gain of $55 million related to the Corporation's oil business in Kuwait. (See Note 6 to the Financial Statements.)

Sales in 1976 were $742 million, an increase of $301 million, or 68 percent, over the prior year. Approximately 85 percent of the increase

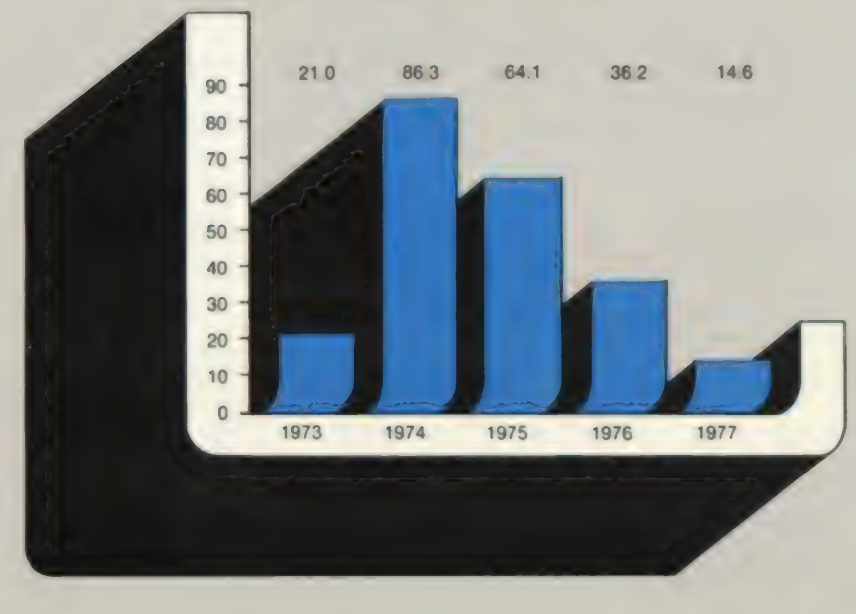
Energy

Sales
(Dollars in Millions)



Energy

Earnings from Operations
(Dollars in Millions)



resulted from the acquisition in June 1976 of the former Burmah properties, with the balance due to improved volumes in the now-nationalized Kuwait operations. Earnings from operations in the same period declined $28 million, or 44 percent, primarily because of higher assessments by foreign governments.

Sales by the energy business were $440 million in 1975, a decrease of $21 million, or 4.5 percent, from 1974. The sales decline resulted from a weak demand for oil during the year, especially during the fourth quarter. Energy earnings from operations for 1975 were $64 million, down $22 million, or 26 percent, from the prior year. The reduced earnings reflect the lower 1975 revenues and increased royalty expenses of $15 million.

Energy sales were $461 million in 1974, an increase of $361 million, and earnings from operations were $86 million, up $65 million over 1973. Almost all of the sales and earnings from operations increases resulted from the quadrupling of posted prices announced by OPEC in late 1973.

Foods and Beverages

RJR Foods manufactures and sells food and beverage products in the United States and Canada. The company's principal product lines include Hawaiian Punch, one of the country's leading fruit drinks, Chun King Oriental foods, and Patio Mexican foods.

RJR Foods' sales rose to $269 million in 1977, a $4.2 million increase over 1976. Volume improvements in the Chun King and Hawaiian Punch Drink Mix lines were a major factor in the sales increase. Earnings from operations rose 7.3 percent to $22 million, compared to $20.5 million in 1976. The increase was primarily attributable to the volume gains, higher selling prices and lower raw material prices. These factors more than offset generally higher marketing and operating expenses.

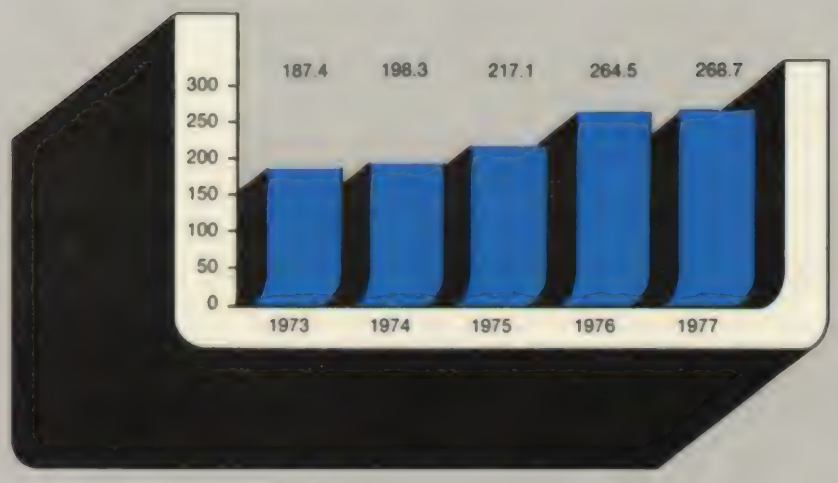
In 1976 RJR Foods introduced its new Hawaiian Punch powdered drink mix. The strong performance of the drink mix, coupled with higher volumes in existing products, resulted in sales of $265 million, an increase of 22 percent over 1975. During 1976, however, earnings from operations decreased 2.4 percent from 1975, primarily due to a $4 million increase in advertising expense (principally relating to the Drink Mix introduction) that more than offset the effect of sales increases and manufacturing efficiencies.

Earnings from operations in 1975 increased $13 million over 1974, primarily as a result of price increases and a decline in the abnormally high sugar prices existing in 1974.

Foods and Beverages

Sales

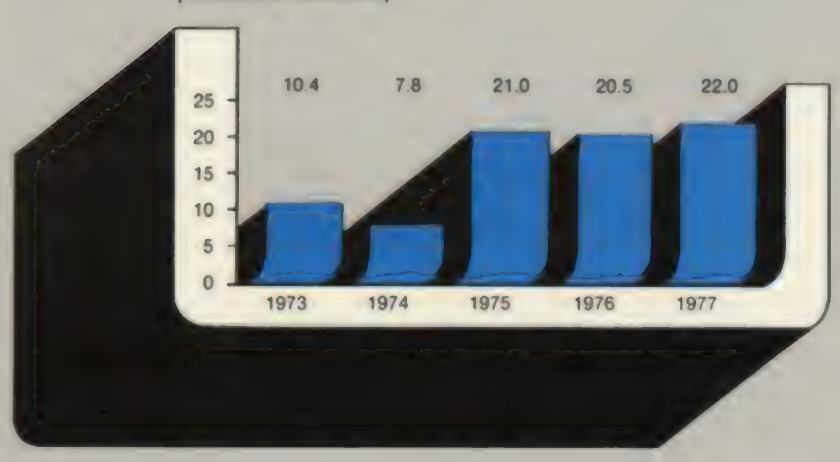
(Dollars in Millions)



Foods and Beverages

Earnings from Operations

(Dollars in Millions)



Earnings from operations in 1974 declined $2.6 million, or 25 percent, from the prior year. The decline was due in large part to the adoption during 1974 of the LIFO method for valuing sugar inventories.

Aluminum Products and Packaging

RJR Archer is primarily involved in the manufacture and sale of printed flexible packaging materials and cartons, aluminum sheet and foil, specialty aluminum products, florist foil and polyvinyl chloride (PVC) packaging film used principally as a protective wrap for meats and produce. Approximately one-third of Archer's sales consist of packaging materials sold to the Corporation's tobacco businesses.

Effective at year-end 1977, RJR Archer sold its ribbon and gift wrap operations. The sale will allow the company to concentrate in areas of growth more compatible with its long-range objectives. Revenues of the operations sold were $24 million in 1977 and $26 million in 1976, and earnings from operations were $2.3 million in 1977 and $1 million in 1976. (Approximately $1.9 million of the 1977 earnings from operations was attributable to the liquidation of LIFO inventories.)

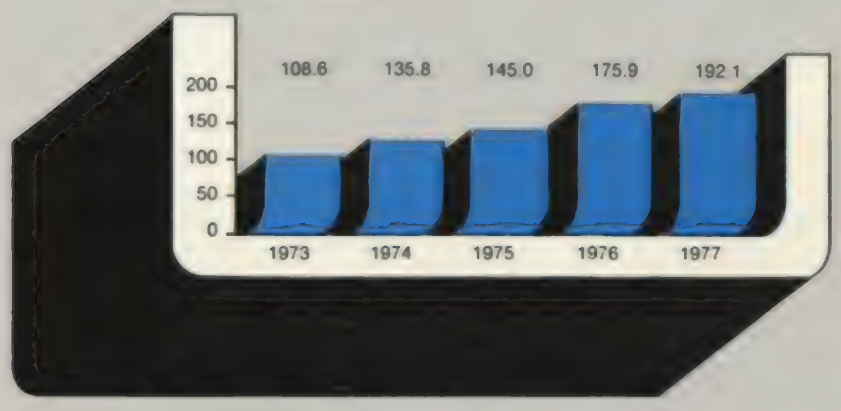
In 1977 Archer's sales increased 9.2 percent to $192 million. Volume increases in the Filmco and Metals divisions were responsible for about 50 percent of the increase. Price increases and product-mix improvements accounted for the balance. Earnings from operations in 1977 increased 26 percent to $17.4 million from $13.8 million in 1976. Approximately half of the $3.6 million increase was due to the volume, price and mix improvements already noted, with most of the remaining increase due to the factors surrounding the sale of certain operations as discussed previously.

During 1976 Archer had sales of $176 million, a $31 million, or 21 percent, increase over 1975. Earnings from operations increased by 38 percent to $13.8 million in 1976, compared with $10 million in 1975. Approximately three-fourths of the sales increase was due to volume improvements, with the remainder attributable to price increases. These sales and price factors were more than sufficient to offset generally higher manufacturing costs, resulting in higher earnings from operations.

In 1974 Archer adopted the LIFO method for valuing certain inventories (principally aluminum). This change was the principal factor in the decrease in earnings from operations of $4.6 million, or 36 percent, in 1974 from 1973.

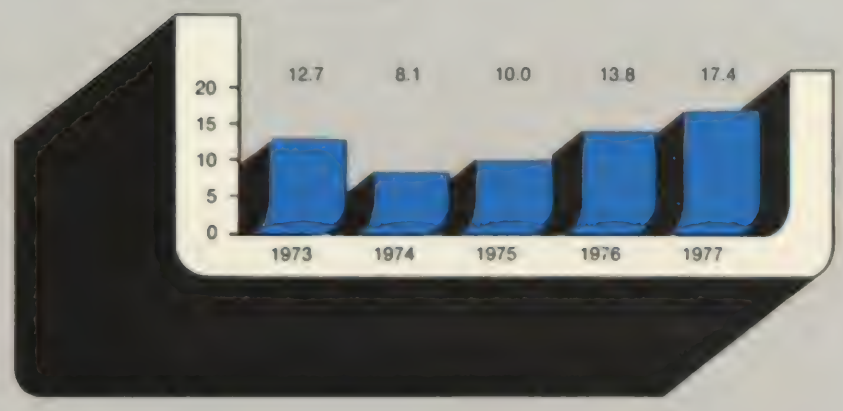
Aluminum Products and Packaging

Sales
(Dollars in Millions)



Aluminum Products and Packaging

Earnings from Operations
(Dollars in Millions)



Interest and Debt Expense

Interest and debt expense increased $13 million, or 19 percent, in 1977 to $84 million. The increase was due almost entirely to the full-year interest cost relating to debt incurred to finance the June 1976 acquisition of the Burmah Oil properties as described in Note 11 to the Financial Statements. The weighted-average annual short-term interest rate (aggregate short-term interest paid as a percentage of the daily average balance of interest-bearing short-term debt) was 8 percent in 1977.

Interest and debt expense was $70 million in 1976, $56 million in 1975, $59 million in 1974 and $42 million in 1973. The $14 million increase in 1976 resulted primarily from the interest on the debt incurred in financing the acquisition as noted above. The $3 million decline in 1975 resulted primarily from the repayment during the year of $29 million of ship mortgage bonds. All years except 1973 include full years' interest on the long-term ship mortgage bonds issued in conjunction with delivery of eight new SL-7 containerships late in 1972 and at various dates in 1973.

The Corporation capitalized as SL-7 vessel cost construction loan interest and commitment fees of $8 million in 1973.

Provision for Income Taxes

The provision for income taxes, as a percent of earnings before taxes, was 46.4 percent in 1977 as compared to 48.8 percent in 1976, 50.7 percent in 1975, 49.2 percent in 1974 and 43.1 percent in 1973. The relatively low 1977 rate resulted from the recognition in the fourth quarter of a $55 million nonrecurring gain that had no tax effect. (See Notes 5 and 6 to the Financial Statements.)

The low 1973 rate was due to high investment tax credits ($30 million) that resulted primarily from expenditures for acquiring and equipping the SL-7 containerships. The Corporation uses the flow-through method of accounting for investment tax credits, whereby the provision for income taxes is reduced in the year the credit first becomes available.

Capital Expenditures

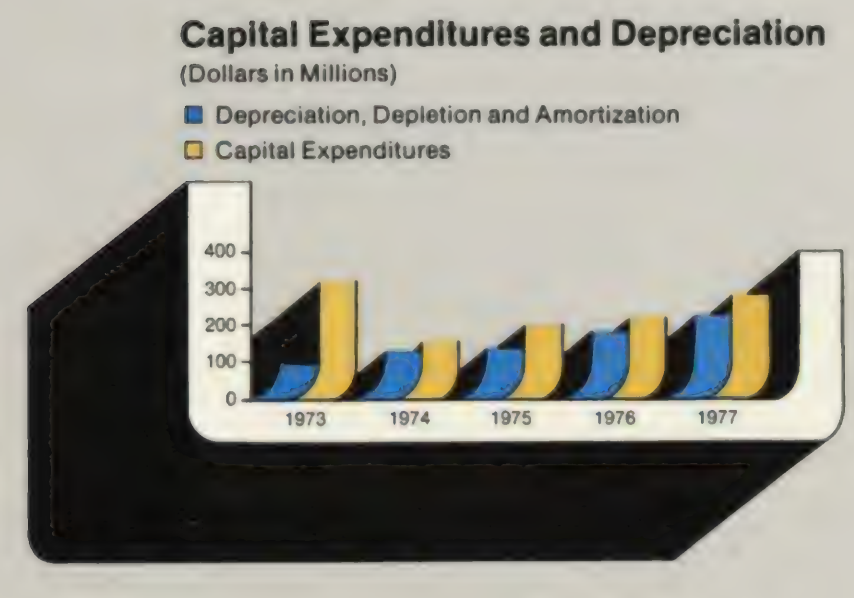
In 1977 capital expenditures were $285 million, compared to $222 million in 1976 and $197 million in 1975.

During the year $69 million was spent in the domestic and international tobacco businesses. Tobacco expenditures in the United States accounted for approximately 85 percent of this amount, including about $10 million for the completion of a new stemmery and tobacco warehouse facilities.

In 1977 Sea-Land commenced a ship-construction program to build four diesel-

Capital Expenditures and Depreciation

(Dollars in Millions)



powered D-6 containerships, utilizing the refurbished midbodies of its T-3 vessels and increasing capacity from 476 to 590 containers. Approximately $19 million was spent on this project in 1977, with completion scheduled for mid-1978. Total capital expenditures in the transportation business for the year were $77 million.

Exploration and development spending totaled $135 million in the energy business in 1977. Of this amount, $33 million represented evaluation and exploration costs which were charged against earnings as incurred. (See the Summary of Significant Accounting Policies for a description of the accounting policies followed in the energy business.) Approximately 90 percent of the exploration and development expenditures related to domestic energy sources.

Capital expenditures totaled $3 million in the foods and beverages business in 1977 and $5 million in the aluminum products and packaging business.

Capital expenditures are projected to total $1.7 billion over the next three years. Approximately $670 million is expected to be spent in the transportation business while expenditures in the energy and domestic tobacco businesses are projected to be about $580 million and $290 million, respectively.

Capital Employed

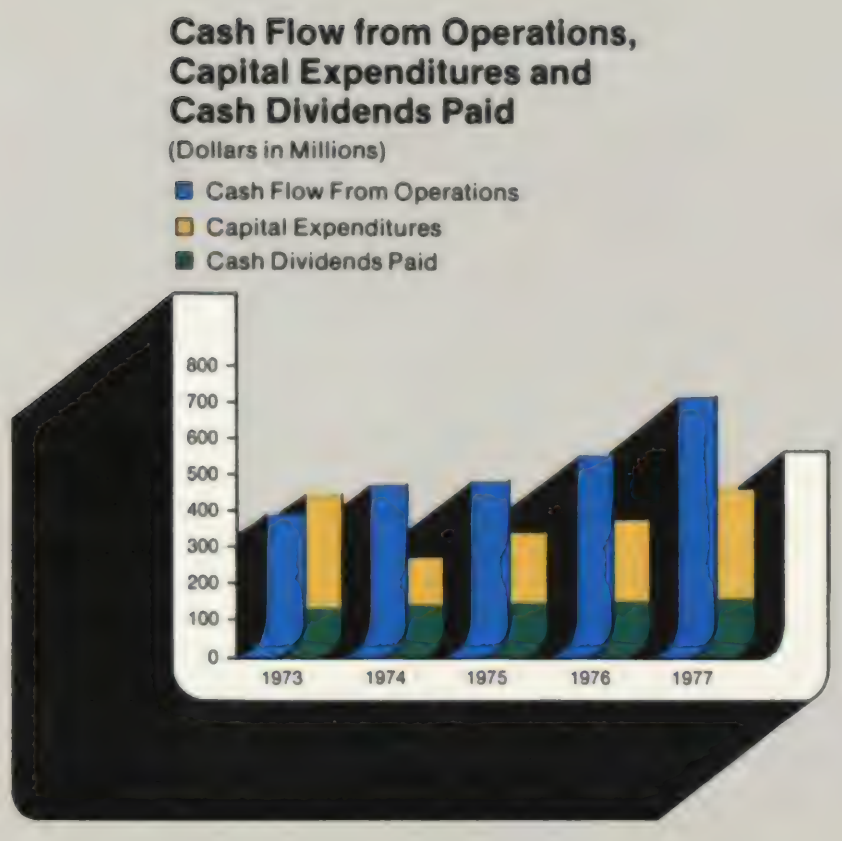
Long-term debt (including current maturities) at year-end totaled $835 million, a $124 million increase over 1976. The increase was due primarily to the issuance in April 1977 of $150 million in 8% Sinking Fund Debentures. The proceeds of the new debt were used to reduce short-term indebtedness (see Note 11 to the Financial Statements) and for working capital.

Since the issuance of Financial Accounting Standards Board Statement No. 8 in October 1975, the Corporation has been required to include in its financial statements the effects of unrealized foreign currency translation gains and losses (ranging from a $30 million loss in 1973 to a $20 million gain in 1975). In November 1977 the Corporation replaced approximately $150 million in long-term ship mortgage bonds, payable in deutsche marks, with five-year notes payable in U.S. dollars. This had the effect of avoiding significant foreign currency losses on this debt as the U.S. dollar continued to decline against the mark through year-end.

Short-term debt at year-end was $175 million, $145 million less than the 1976 year-end amount. Most of the year-to-year decline

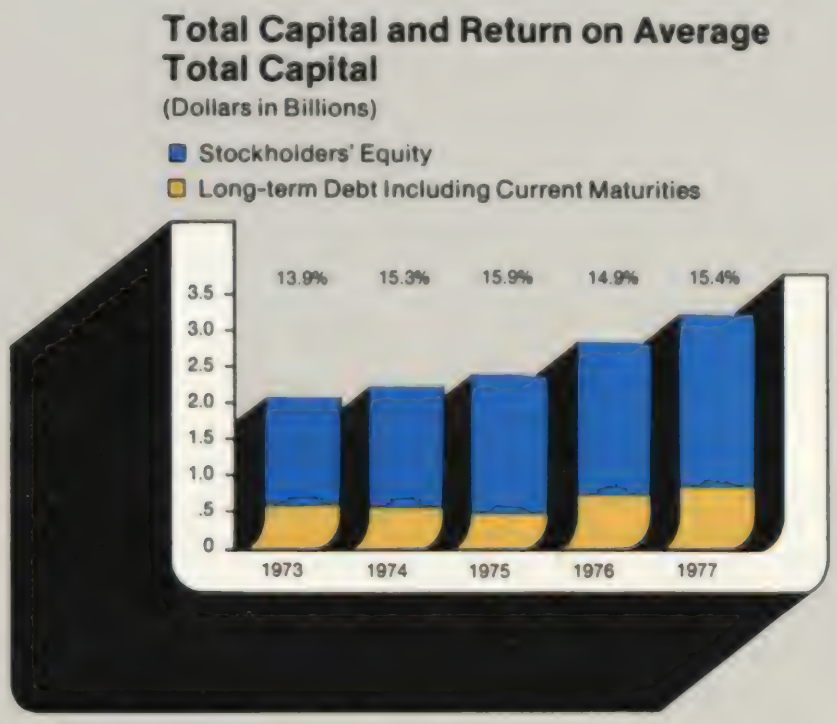
Cash Flow from Operations, Capital Expenditures and Cash Dividends Paid

(Dollars in Millions)



Total Capital and Return on Average Total Capital

(Dollars in Billions)



was due to the replacement of short-term debt in April 1977 as described above.

Total long-term debt as a percentage of total capital was 26 percent at December 31, 1977, and 25 percent at December 31, 1976, and has averaged 25 percent for the last five years.

During 1977 the Corporation received $27 million from the conversion of 1,241,525 shares of Preferred Stock into 1,862,271 shares of RJR Common Stock. These proceeds were added to the Corporation's general funds.

Dividends and Stock Prices

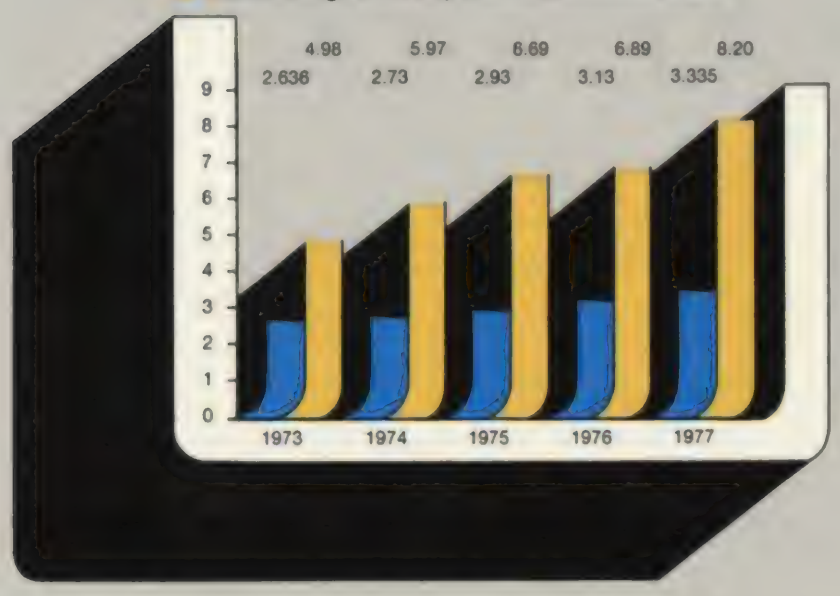
In the fourth quarter of 1977, the Corporation increased the quarterly dividend on Common Stock from 82 cents to 87½ cents per share. The dividend payment per common share has increased each year for the past 24 years except for 1971, when dividend increases were prohibited by federal economic guidelines. This is the 78th consecutive year R.J. Reynolds has paid a dividend. Dividends declared on the Common and Preferred Stocks during 1977 totaled a record $166.7 million.

Since the issuance of the $2.25 Convertible Preferred Stock in May 1969, the Corporation has paid the regular dividend of 56¼ cents per share each quarter. The following table sets forth the dividends paid per share of Common Stock and the high and low sales prices of the Common and Preferred Stocks during the last two years:

	Common Stock		Preferred Stock
Quarters	Dividends	Market Price (High-Low)	Market Price (High-Low)
1977			
First	**$ .82**	**70 - 63¼**	**82 - 73**
Second	**.82**	**69½ - 63¼**	**81½ - 73**
Third	**.82**	**70⅝ - 60⅛**	**83¾ - 68**
Fourth	**.87½**	**65¾ - 58**	**76¼ - 65½**
Year	**$3.33½**	**70⅝ - 58**	**83¾ - 65½**
1976			
First	$ .77	68¼ - 61¾	80 - 70
Second	.77	62⅝ - 55	71½ - 61
Third	.77	63⅝ - 56⅜	72½ - 62½
Fourth	.82	67⅞ - 59¼	79 - 70
Year	$3.13	68¼ - 55	80 - 61

Net Earnings Per Fully Diluted Common Share and Dividends Per Common Share

(Dollars)



Summary of Significant Accounting Policies

Years Ended December 31, 1977 and 1976

This summary of significant accounting policies is an integral part of the accompanying financial statements and is presented to assist in understanding the Company's financial statements included in this report. These policies conform to generally accepted accounting principles and have been consistently followed by the Company in all material respects.

Consolidation

The Company includes in its consolidated financial statements the accounts of the parent and all subsidiaries.

Inventories

Materials and supplies used in the transportation business are valued at lower of cost (FIFO) or market.

In the Company's aluminum products and packaging and domestic tobacco businesses, inventories, including supplies and manufactured products, are stated at cost (most of which are valued using the LIFO method - see Note 2).

Inventories in the international tobacco business are valued under various methods, principally LIFO and average cost.

The Company's foods and beverages business values inventories at the lower of cost or market. The weighted average method is used to determine cost for all inventories except sugar, which is determined by the LIFO method.

Inventories of crude oil and refined products are carried at cost (FIFO) and inventories of supplies and materials in the energy business are carried at average cost. The aggregate cost of inventories is not in excess of the market value.

Depreciation, Depletion and Amortization

Except as noted below, properties and equipment in all businesses are depreciated using the straight-line method. Those assets acquired prior to January 1, 1977, which are used in the Company's domestic manufacturing businesses are depreciated using principally accelerated methods. The straight-line method of depreciation was adopted for assets acquired by these businesses after 1976 to conform with the depreciation method previously applied to the majority of the Company's assets and with general industry practice. The adoption of straight-line depreciation for new domestic manufacturing

assets had no material effect upon the Company's financial statements.

Leasehold costs for undeveloped oil and gas properties are capitalized and amortized over a five-year evaluation period, or over the life of the leasehold, whichever is shorter. Upon discovery of commercial hydrocarbon reserves, the unamortized balance of the leasehold cost is amortized on the unit-of-production method based on an estimate of recoverable reserves on a lease-by-lease basis. Tangible and intangible drilling costs are capitalized until the results of the drilling activity are evaluated. Upon evaluation, such drilling costs are charged to income or, if successful, amortized on the unit-of-production method. All other exploration costs are charged against earnings as incurred. In December 1977 the Financial Accounting Standards Board published Statement No. 19, which establishes accounting standards to be followed by oil and gas producing companies for fiscal years beginning after December 15, 1978. Since the Company has historically used the "successful efforts" method of accounting in its energy business, implementation of Statement No. 19 is not expected to have a material effect on the Company's financial statements.

In all businesses, renewals, conversions or betterments which add materially to the value or useful lives of property are charged to property, plant and equipment accounts.

Intangible Assets

The excess of cost over net assets of businesses acquired subsequent to October 31, 1970, is being amortized over periods not exceeding 40 years. Generally, amounts recorded prior to that date are not being amortized since the Company believes no permanent impairment of the value of these assets has occurred.

Sales and Revenues

Sales of products, which include certain excise taxes (see Note 1), are recognized in income as customer shipments are made. Transportation revenues and related vessel voyage expenses are generally recognized at the commencement of a voyage.

Other Income and Expense

The Company includes in other income (expense), net, items of a financial nature, principally interest income.

Income Taxes

The Company uses the flow-through method in accounting for investment tax credits whereby the provision for income taxes is reduced in the year the tax credits first become available rather than deferring the credit over the life of the related asset.

Certain of the Company's foreign petroleum operations are covered by special income tax agreements with foreign governments. The agreements generally specify a level of income tax in excess of the customary corporate income tax rate prevailing in those countries. For financial reporting purposes, the Company classifies these excess taxes as operating expenses (see Note 5).

Earnings Per Share

Primary earnings per share are determined by dividing net earnings applicable to Common Stock by the average number of common shares and equivalent common shares outstanding.

Fully diluted earnings per share are calculated using the "treasury stock" method. This method assumes that all shares of the Convertible Preferred Stock outstanding during the year were converted into Common Stock and the conversion proceeds used to purchase treasury common shares at the higher of the average daily price or year-end closing price of the Common Stock.

R.J.Reynolds Industries, Inc.

Consolidated Statements of Earnings and Earnings Retained

For the Years Ended December 31 *(Dollars in Millions Except Per Share Statistics)*

	1977	1976
Net sales and revenues (Note 1)	**$6,363.1**	$5,753.6
Costs and expenses:		
Cost of products sold and operating expenses (Note 5)	**4,773.4**	4,304.1
Selling, advertising, administrative and general expenses	**775.7**	669.9
Earnings from operations	**814.0**	779.6
Interest and debt expense	**(83.5)**	(70.4)
Other income (expense), net	**16.3**	7.6
	746.8	716.8
Foreign currency gains (losses)	**(11.7)**	(26.9)
Nonrecurring gain (Note 6)	**55.1**	—
Earnings before provision for income taxes	**790.2**	689.9
Provision for income taxes (Note 5)	**366.7**	336.7
Net earnings	**423.5**	353.2
Less preferred dividends	**7.4**	10.2
Net earnings applicable to Common Stock	**416.1**	343.0
Earnings retained at beginning of year	**1,717.7**	1,519.0
Cash dividends on Common Stock	**159.3**	143.7
Charges related to stock options exercised (Note 8)	**0.5**	0.6
Earnings retained at end of year	**$1,974.0**	$1,717.7
Net earnings per common share:		
Primary	**$8.72**	$7.47
Fully diluted	**8.20**	6.89
Average number of common shares outstanding (in thousands):		
Primary	**47,729**	45,924
Fully diluted	**51,628**	51,289

The Summary of Significant Accounting Policies, the Notes to Consolidated Financial Statements, and the Lines of Business and Geographic Data on pages 58, 59 and 60 are an integral part of these financial statements.

R.J.Reynolds Industries, Inc.

Consolidated Balance Sheets

December 31 *(Dollars in Millions)*

	1977	1976
ASSETS		
Current assets:		
Cash and short-term investments	**$ 94.2**	$ 105.5
Accounts and notes receivable (less allowances of $14.7 and $10.9, respectively)	**539.7**	481.0
Inventories (Note 2)	**1,353.8**	1,403.8
Prepaid expenses	**32.8**	18.7
Total current assets	**2,020.5**	2,009.0
Property, plant and equipment - at cost (Notes 3 and 9)	**2,935.3**	2,807.9
Less allowances for depreciation, depletion and amortization	**937.7**	849.7
Net property, plant and equipment	**1,997.6**	1,958.2
Cost in excess of net assets of businesses acquired	**165.5**	170.4
Other assets and deferred charges	**150.4**	152.0
	$4,334.0	$4,289.6
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Notes payable	**$ 174.7**	$ 319.4
Accounts payable and accrued accounts	**554.4**	462.6
Current maturities of long-term debt (Note 4)	**74.5**	50.7
Income taxes accrued	**37.3**	147.6
Total current liabilities	**840.9**	980.3
Long-term debt (less current maturities) (Note 4)	**760.6**	660.8
Other noncurrent liabilities	**81.9**	81.7
Deferred revenue (Note 11)	**7.6**	263.3
Deferred income taxes (Note 5)	**251.3**	192.6
Stockholders' equity (Note 8):		
Preferred Stock	**31.5**	44.6
Common Stock - net	**238.4**	231.9
Paid-in capital	**147.8**	116.7
Earnings retained (Note 4)	**1,974.0**	1,717.7
Total stockholders' equity	**2,391.7**	2,110.9
	$4,334.0	$4,289.6

The Summary of Significant Accounting Policies, the Notes to Consolidated Financial Statements, and the Lines of Business and Geographic Data on pages 58, 59 and 60 are an integral part of these financial statements.

R.J.Reynolds Industries, Inc.

Consolidated Statements of Changes in Financial Position

For the Years Ended December 31 *(Dollars in Millions)*

	1977	1976
Working capital was provided by:		
Operations:		
Net earnings	**$ 423.5**	$ 353.2
Depreciation, depletion and amortization	**223.2**	175.2
Deferred income taxes	**63.7**	(0.6)
Long-term foreign currency translation losses	**11.0**	18.9
Other	**0.7**	5.6
Total from operations	**722.1**	552.3
Deferred revenue from sale of oil and gas production (Note 11)	**—**	280.0
Proceeds from long-term debt	**168.8**	133.5
Proceeds from issuance of Company's stock	**42.1**	22.0
Other (principally disposals of property, plant and equipment)	**41.4**	18.8
	974.4	1,006.6
Working capital was used for:		
Net increase in long-term assets from acquisition accounted for as a purchase (Note 11)	**—**	495.1
Capital expenditures	**284.6**	221.7
Cash dividends	**166.7**	153.9
Long-term debt becoming currently payable	**78.7**	47.7
Retirement of Preferred Stock upon conversion	**13.1**	6.6
Reduction in deferred revenue (Note 11)	**255.7**	25.7
Cost of treasury shares purchased	**5.0**	2.2
Other (principally other assets and deferred charges)	**19.7**	8.0
	823.5	960.9
Increase in working capital	**$ 150.9**	$ 45.7
Analysis of change in working capital:		
Increase (decrease) in current assets:		
Cash and short-term investments	**$ (11.3)**	$ 70.2
Accounts and notes receivable	**58.7**	101.4
Inventories	**(50.0)**	134.5
Prepaid expenses	**14.1**	5.5
Decrease (increase) in current liabilities:		
Notes payable	**144.7**	(209.8)
Accounts payable and accrued accounts	**(91.8)**	(115.0)
Current maturities of long-term debt	**(23.8)**	(10.4)
Income taxes accrued	**110.3**	69.3
Increase in working capital	**$ 150.9**	$ 45.7

The Summary of Significant Accounting Policies, the Notes to Consolidated Financial Statements, and the Lines of Business and Geographic Data on pages 58, 59 and 60 are an integral part of these financial statements.

Notes to Consolidated Financial Statements

Note 1
Excise Taxes

Net sales and revenues include excise taxes on tobacco and petroleum products as indicated in the following table:

	(Dollars in Millions)	
	1977	1976
Domestic tobacco	**$ 852.6**	$ 849.7
International tobacco	**678.9**	603.5
Petroleum	**15.6**	9.2
	$1,547.1	$1,462.4

Note 2
Inventories

The major classes of inventory and the amount of each at December 31 were:

	(Dollars in Millions)	
	1977	1976
Leaf tobacco	**$1,025.0**	$1,067.7
Manufactured products	**93.5**	89.6
Excise tax on manufactured products	**72.9**	72.8
Petroleum products	**26.3**	29.0
Other materials and supplies	**136.1**	144.7
	$1,353.8	$1,403.8

At December 31, 1977 and 1976, respectively, $964.3 million and $985.7 million of the inventory was valued by the last-in, first-out (LIFO) method. The balance of the inventory was valued by various other methods, principally first-in, first-out (FIFO).

The current replacement value at December 31, 1977 and 1976, of inventories was approximately $745.1 million and $652.7 million, respectively, greater than the amounts at which these inventories were carried in the balance sheets.

Note 3
Property, Plant and Equipment

Components of property, plant and equipment at December 31 are shown in the table below:

	(Dollars in Millions)	
	1977	1976
Land and land improvements	**$ 38.4**	$ 28.2
Buildings and leasehold improvements	**288.0**	241.3
Machinery and equipment	**527.0**	481.7
Vessels, containers and other marine equipment	**1,236.7**	1,193.9
Energy related leasehold properties	**730.7**	765.6
Construction-in-process	**114.5**	97.2
	2,935.3	2,807.9
Less allowances for depreciation, depletion and amortization	**937.7**	849.7
Net property, plant and equipment	**$1,997.6**	$1,958.2

Note 4
Long-term Debt

	(Dollars in Millions)			
	December 31, 1977		December 31, 1976	
	Due Within One Year	**Due After One Year (e)**	Due Within One Year	Due After One Year
Long-term debt consists of the following:				
7½% Ship Mortgage Bonds, payable in deutsche marks with semi-annual sinking fund payments through 1987 (a) (b)	**$ —**	**$ —**	$15.5	$145.3
8½% and 8¾% Ship Mortgage Bonds, payable in Dutch guilders with semi-annual sinking fund payments through 1981 (b)	**15.1**	**37.6**	13.9	48.5
7⅜% Debentures, due February 1, 2001, with annual sinking fund payments beginning in 1982	**—**	**100.0**	—	100.0
7⅞% Debentures, with annual sinking fund payments through 1994 (reduced by $0.5 million of such Debentures held by the Company on December 31, 1976, for future sinking fund requirements)	**5.0**	**80.0**	4.5	85.0
8% Debentures, due January 15, 2007, with semi-annual sinking fund payments beginning in 1988	**—**	**150.0**	—	—
8.9% Notes, due October 1, 1996, with annual prepayments beginning in 1981 (c)	**—**	**100.0**	—	100.0
7½% Notes, due November 18, 1982, with equal annual sinking fund payments through 1982 (a)	**32.0**	**128.0**	—	—
7% Subordinated Debentures, due June 1, 1989, with annual sinking fund payments beginning in 1980	**—**	**15.8**	—	15.8
Exploration and development advances (d)	**9.0**	**95.8**	0.3	105.3
Capitalized lease obligations	**2.5**	**15.9**	1.9	14.6
Other indebtedness with various interest rates and maturities	**10.9**	**37.5**	14.6	46.3
	$74.5	**$760.6**	$50.7	$660.8

(a) The 7½% Ship Mortgage Bonds, payable in deutsche marks, were replaced in November 1977 with 7½% eurodollar notes payable in U.S. dollars.

(b) The net book value of assets classified as vessels, containers and other marine equipment subject to the liens of ship mortgage bonds and other indebtedness was $126.3 million at December 31, 1977, and $390.2 million at December 31, 1976.

(c) Under the terms of the Company's 8.9% Notes, dividend payments are generally limited to $150 million, plus net earnings after December 31, 1975. At December 31, 1977, $606.1 million of earnings retained were unrestricted.

(d) At December 31, 1977, the Company had $104.8 million of advances from certain gas pipeline companies ($92.4 million of which was noninterest bearing) for the financing of exploration and development of various leases in the Gulf of Mexico in consideration for undertaking to execute gas purchase and sale agreements for future natural gas production. Current projections indicate repayment of the advances will be as follows (dollars in millions): 1978 - $9.0; 1979 - $12.7; 1980 - $14.2; 1981 - $41.3; 1982 - $16.8; 1983 and later - $10.8.

(e) The payment schedule of debt due after one year (including the exploration advances referred to above) is as follows (dollars in millions): 1979 - $76.7; 1980 - $88.7; 1981 - $97.9; 1982 - $68.6; 1983 and later - $428.7.

Note 5
Provision for Income Taxes

Under the Company's accounting policy, certain foreign income taxes on petroleum operations amounting to $165.4 million and $199.4 million for the years ended December 31, 1977 and 1976, respectively, were classified as operating expenses. (See the Summary of Significant Accounting Policies.)

The provision for income taxes (excluding amounts classified as operating expenses) consists of the following:

	(Dollars in Millions)	
	1977	1976
Current:		
Federal	**$238.2**	$268.8
State	**39.0**	33.4
Foreign	**25.8**	35.1
Total	**303.0**	337.3
Deferred:		
Federal	**60.2**	(3.7)
State	**1.1**	1.5
Foreign	**2.4**	1.6
Total	**63.7**	(0.6)
Provision for income taxes	**$366.7**	$336.7

Deferred income tax expense (benefit) results from timing differences in the recognition of revenue and expense for book and tax purposes. The sources of these differences and the tax effect of each were as follows:

	(Dollars in Millions)	
	1977	1976
Excess of tax over book depreciation	**$12.5**	$24.0
Intangible drilling and development costs	**29.8**	11.3
Various other items	**21.4**	(35.9)
Deferred income taxes	**$63.7**	$ (0.6)

The effective tax rate was 46.4 percent in 1977 and 48.8 percent in 1976. The differences between the amounts recorded and the amounts computed by applying the federal income tax rate of 48 percent to earnings before provision for income taxes are explained as follows:

	(Dollars in Millions)			
	1977		1976	
	Amount	**% of Pre-tax Income**	Amount	% of Pre-tax Income
Income tax computed at statutory U.S. federal income tax rate	**$379.3**	**48.0%**	$331.2	48.0%
Effect of nonrecurring gain (see Note 6)	**(26.4)**	**(3.3)**	—	—
Taxes on foreign operations in excess of statutory U.S. federal income tax rate	**5.6**	**0.7**	5.8	0.8
State taxes, net of federal benefit	**21.2**	**2.7**	18.1	2.6
Investment tax credit	**(12.3)**	**(1.6)**	(9.8)	(1.4)
Miscellaneous items	**(0.7)**	**(0.1)**	(8.6)	(1.2)
Provision for income taxes*	**$366.7**	**46.4%**	$336.7	48.8%

*Excluding $165.4 million and $199.4 million classified as operating expenses in 1977 and 1976, respectively. (See the Summary of Significant Accounting Policies.)

No provision has been made for U.S. income taxes (not material in amount) that would be payable upon remittance of earnings retained abroad by foreign subsidiaries, since it is the Company's intention to reinvest these earnings abroad.

There are a number of issues pending as a result of Internal Revenue Service audits, none of which are expected to have a material adverse effect on the Company's financial statements (see Note 7).

Note 6
Nonrecurring Gain

During 1977 and 1976 the Company was engaged in negotiations with the government

of Kuwait regarding the terms of a new relationship concerning the Company's petroleum operations in Kuwait and in the Divided Zone between Kuwait and Saudi Arabia. During the period of these negotiations the Company accrued $55.1 million — covering the years 1975, 1976 and 1977 — in line with new payment arrangements then under discussion with government representatives.

Negotiations terminated in September 1977 when the government of Kuwait nationalized the Company's assets in its territories. As a result the Company believes, based on the opinion of counsel, that those amounts previously accrued will not be payable. This change in estimate has been accounted for as a nonrecurring gain. The gain had no effect on the provision for income taxes while earnings before provision for income taxes and net earnings were increased by $55.1 million in the fourth quarter of 1977. (See Note 7 for further information relating to the nationalization.)

Note 7
Commitments and Contingencies

Three civil actions purporting to be class actions, two of which were brought in 1974 and one of which was brought in 1975, are pending against the six major U.S. cigarette manufacturers, including the Company, and others in which certain tobacco farmers allege violations of the antitrust laws and seek damages of approximately $43 million, $336 million and an unspecified amount, respectively, plus attorneys' fees and costs. In one of the cases, the trial court held in 1975 that the action was not a proper class action and the decision was affirmed by a U.S. Court of Appeals in 1977, but plaintiffs have filed a petition for certiorari with the U.S. Supreme Court. The Company believes, based on opinion of counsel, that none of these cases is a proper class action, in which event none of the cases should result in any material liability. Investigation of the merits of the three cases is not complete, but the Company, based on the investigation and the formal discovery to date, believes that it has substantial factual and legal defenses on the merits to the charges made. Accordingly, the Company has made no provision for these cases in its financial statements.

The U.S. Attorney for the Middle District of North Carolina, acting in conjunction with the U.S. Attorney for the District of New Jersey, and with the assistance of special agents of the Internal Revenue Service Intelligence Division, is conducting an investigation of various matters which were investigated by the Company as part of its own "questionable payments" investigation. The results of the Company's investigation, which was conducted as part of its participation in the Securities and Exchange Commission ("SEC") voluntary disclosure program, were reported in 8-K filings made with the SEC in May and September of 1976 which disclosed certain questionable foreign payments, rebates to shippers, use of Company funds for domestic political contributions and related matters. The combined federal investigation concerns possible criminal violations of U.S. tax and other laws arising from rebating, domestic political contributions and, possibly, from the other payments referred to above. The Company's disclosures — like those of many others in the voluntary program — are also under investigation by the SEC. In the opinion of the Company, rebates have not given rise to any improper deductions on the Company's U.S. consolidated federal income tax return and should not lead to indictment under criminal provisions of the Internal Revenue Code. Nor does it appear likely to the Company that these or other payments will lead to indictments under federal criminal laws. However, the Company cannot predict what action, if any, will be taken in, or as a result of, the foregoing matters. While it is impossible to estimate the ultimate liability, if any, which may arise out of the Company's investigation and the ensuing

federal and SEC investigations, the Company is of the opinion that additional liability, if any, will not have a material adverse effect on its financial statements.

A federal grand jury in Washington, D.C., is investigating possible violations of the antitrust laws in the ocean transportation of freight. Although the Company is unable to predict what action, if any, will be taken by or as a result of the grand jury investigation, the Company is of the opinion that if any liability arises from the grand jury investigation, it will not have a material adverse effect on the Company's financial statements.

On September 19, 1977, the government of Kuwait issued a decree nationalizing the Company's oil business in that country and in the Divided Zone between Kuwait and Saudi Arabia. Net sales attributable to the nationalized business for the years ended December 31, 1977 and 1976, were $244.4 million and $303.5 million, respectively. Earnings from operations for the years ended December 31, 1977 and 1976, were $8.2 million and $34.8 million, respectively. At December 31, 1977, the liabilities of the Company pertaining to the nationalized business, net of related assets, have been included in noncurrent liabilities. The decree provides, among other things, for the formation of a committee to assess compensation due to and obligations of the Company. The obligations may include royalties, income taxes, termination benefits and other items. A formal request for arbitration has been made of the Kuwait government. Management regards it as unlikely that the amount of the obligations will exceed the compensation as ultimately determined by the committee, by arbitration or otherwise. In light of the uncertainties involved, the amount of any ultimate gain or loss, as the case may be, is indeterminable at this time. However, the Company believes that the resolution of the foregoing will not have a material adverse effect on its financial statements. (See Note 6 for information concerning a nonrecurring gain connected with the nationalization.)

Aminoil USA, Inc., as successor to a business acquired on June 30, 1976, has been named as one of the defendants in an action instituted by Florida Power Corporation in a U.S. District Court in Florida. The action is based upon allegations in an amended complaint that certain of the individual and corporate defendants unlawfully conspired to sell heating oil to Florida Power during 1973 and 1974 at prices in excess of those allowed by law. The complaint alleges that those acts constitute violations of the Robinson-Patman Act, the Sherman Act, regulations adopted by the Federal Energy Administration, Florida statutory law, and common law. Damages in excess of $10 million are sought. Although the suit is in its very early stages, the Company believes that resolution of the matter will not have a material adverse effect on the Company's financial statements.

There are certain other claims and pending actions against the Company and its subsidiaries which in the aggregate are not expected to have any material adverse effect on the Company's financial statements. The Company had various capital spending commitments of $87 million at December 31, 1977. For additional information concerning commitments and contingencies, see Notes 5 and 9.

Note 8
Capital Changes and Related Matters

Each share of the Preferred Stock is convertible into 1.5 shares of the Company's Common Stock on surrender of the preferred share and payment of $22 in cash. Upon conversion, the cash proceeds and the stated value of the converted preferred shares less the par value of the common shares issued is credited to paid-in capital. The Company may call for redemption of the Preferred Stock after June 30, 1979, at $50 per share (aggregating $148.9 million at December 31, 1977) plus accrued dividends to the redemption date. In the event of involuntary liquidation, holders of the Preferred Stock are entitled to $10.57 per share plus accrued dividends. Of the authorized but unissued common shares at December 31, 1977, 4,467,927 were reserved

	(Dollars in Millions)	
	1977	1976
$2.25 Convertible Preferred Stock — without par value ($10.57 stated value): Authorized 2,990,568 shares and 4,232,093 shares at December 31, 1977 and 1976, respectively; 2,978,618 shares and 4,220,143 shares issued at December 31, 1977 and 1976, respectively.		
Balance at beginning of year	**$ 44.6**	$ 51.2
Shares converted into Common Stock (1,241,525 shares in 1977 and 628,142 in 1976)	**(13.1)**	(6.6)
Balance at end of year	**$ 31.5**	$ 44.6
Common Stock — par $5: Authorized 60,000,000 shares; 48,245,313 shares and 46,383,042 shares issued at December 31, 1977 and 1976, respectively.		
Balance at beginning of year	**$231.9**	$227.2
Shares issued upon conversion of Preferred Stock (1,862,271 shares in 1977 and 942,207 shares in 1976)	**9.3**	4.7
Less Common Stock held in treasury-at cost: 45,300 shares at December 31, 1977.	**(2.8)**	—
Balance at end of year	**$238.4**	$231.9
Treasury Common Stock		
Balance at beginning of year	**$ —**	$ —
Purchased (78,935 shares in 1977 and 33,601 shares in 1976)	**5.0**	2.2
Sales upon exercise of stock options (33,635 shares in 1977 and 33,601 shares in 1976)	**(1.7)**	(1.6)
Amount charged to earnings retained (difference between option price and cost of treasury stock)	**(0.5)**	(0.6)
Balance at end of year	**$ 2.8**	$ —
Paid-in capital		
Balance at beginning of year	**$116.7**	$101.0
Net proceeds from conversion of Preferred Stock into Common Stock	**31.1**	15.7
Balance at end of year	**$147.8**	$116.7

for conversion of 2,978,618 shares of preferred shares issued.

The Company has two stock option plans that provide for the granting of options to purchase shares of the Company's Common Stock to certain officers and other employees as may be recommended by the chairman of the board or president of the Company. The option price is the average quoted market price on the date of the grant. Options granted that lapse or are canceled prior to exercise are added back to the shares authorized for future options.

Under the Career Executive Stock Plan, approved by the stockholders at the 1974 annual meeting, the maximum number of shares of the Company's Common Stock that may be purchased is 600,000 and individual purchases are limited to 30,000 shares. The plan permits the granting of both qualified and nonqualified options (as defined under the Internal Revenue Code) that may run for periods of up to five years as to qualified and up to 10 years as to nonqualified options. However, no option may be exercised prior to one year after the date of grant. In 1977 and 1976, 20,000 and 215,750 options, respectively, were granted under this plan.

Under the 1977 Stock Option Plan, approved by the stockholders at the 1977 annual meeting, the maximum number of shares of the Company's Common Stock that may be purchased is 1,250,000 and individual purchases are limited to 50,000 shares. The options are exercisable in cumulative annual installments of 25 percent of the optioned shares beginning one year from date of grant and expiring in 10 years. The plan also provides for granting stock appreciation rights

to holders of options under this plan and the Career Executive Stock Plan, permitting them to surrender exercisable options in exchange for shares of the Company's Common Stock having an aggregate market value, at the time of surrender, equal to the difference between the option price and the market value of shares covered by surrendered options, or to receive all or part of such difference in cash. Shares covered by the surrendered stock options or portions thereof may not again be subjected to option. At December 31, 1977, 45,300 shares of the Company's Common Stock were held as Treasury Stock in anticipation of settlement of stock appreciation rights. In 1977, 234,950 options were granted under the 1977 Plan and at December 31, 1977, outstanding options for 642,003 shares had stock appreciation rights attached.

Under both stock option plans, no charges or credits to earnings are made in connection with either the granting of options or exercise thereof. Compensation expense is accrued in anticipation of settlement of stock appreciation rights over the period they become exercisable.

The following table summarizes the changes in options outstanding at December 31, 1977 and 1976:

	1977	1976
Outstanding at beginning of year...	**487,099**	311,200
Granted.....	**254,950**	215,750
Exercised	**(33,635)**	(33,601)
Canceled.....	**(2,250)**	(6,250)
Outstanding at end of year.....	**706,164**	487,099
Price Ranges:		
Granted.....	**$64.69-$70.19**	$59.06-$63.56
Exercised:		
Option price.....	**$43.44-$59.06**	$43.44-$57.56
Market price.....	**$59.62-$70.00**	$56.75-$67.87
Outstanding at end of year.....	**$43.44-$70.19**	$43.44-$63.56

At December 31, 1977, options were exercisable as to 451,714 shares compared with 271,849 shares at December 31, 1976. As of December 31, 1977, options for 1,067,050 shares of the Company's Common Stock were available for future grants.

Note 9
Leases

During 1977 the Company changed its method of accounting for leases in conformity with the requirements of Statement No. 13 published by the Financial Accounting Standards Board in November 1976. All prior years have been restated to reflect this change. The effect of the change on fully diluted earnings per common share did not exceed two cents for any year restated.

Leases for vessels, truck terminals, port facilities and related equipment are used extensively in connection with the transportation business. Most such leases contain ordinary renewal options, although some container equipment leases provide for bargain renewal options extending over the economic life of the property. Some of the truck terminal and port facility leases contain escalation clauses based on the lessor's operating costs, and certain port facility leases call for contingent rentals based on usage.

While most of the Company's leases are noncancelable operating leases relating to port facilities, such leases have not been capitalized based on the provisions of Statement No. 13. Property, plant and equipment accounts at December 31 include the following amounts for capital leases (relating mainly to truck terminals and container equipment):

	(Dollars in Millions)	
	1977	1976
Buildings and leasehold improvements	**$12.5**	$13.3
Machinery and equipment	**3.4**	0.7
Vessels, containers and other marine equipment	**16.7**	14.7
	32.6	28.7
Less allowances for amortization*.....	**13.4**	10.9
	$19.2	$17.8

*Lease amortization is included in depreciation expense.

At December 31, 1977, the Company was obligated under capital and noncancelable operating leases to make future minimum lease payments as follows:

	(Dollars in Millions)		
	Capital Leases	Non-cancelable Operating Leases	Total
1978	$ 4.8	$ 52.3	$ 57.1
1979	3.8	46.7	50.5
1980	3.4	42.0	45.4
1981	3.2	33.2	36.4
1982	2.7	32.2	34.9
Thereafter	19.1	269.5	288.6
Total minimum lease payments	37.0	$475.9	$512.9
Executory costs	(7.5)		
Amount representing interest	(11.1)		
Capitalized lease obligations (see Note 4)	$18.4		

Minimum future sublease rentals receivable under capital leases and noncancelable operating leases at December 31, 1977, amounted to $3.8 million and $3.1 million, respectively. Rental expense for all operating leases, cancelable and noncancelable, consisted of:

	(Dollars in Millions)	
	1977	1976
Minimum rentals	$96.7	$86.6
Contingent rentals	0.6	0.3
Sublease rental income	(2.7)	(3.9)
	$94.6	$83.0

Note 10
Pension Plans

The Company provides retirement benefits for substantially all of its regular full-time employees through Company-administered plans and plans administered under collective bargaining agreements. The Company's policy with respect to Company-administered plans is to fund pension costs accrued.

The cost of the Company-administered plans is determined on the basis of various actuarial assumptions, the principal ones being: a 6 percent assumed rate of future earnings on Pension Trust assets, including systematic recognition of a portion of the unrealized appreciation or depreciation in the value of common stocks in the trust fund; and amortization of unfunded prior service cost over a 30-year period.

Pension expense was $43 million in 1977 and $40 million in 1976. According to the most recent actuarial valuations, the value of vested benefits exceeds the assets of the Company-administered plans by $20 million, and the unfunded prior service cost was $159 million.

The Company makes payments under the terms of various collective bargaining agreements to provide welfare benefits, including pension benefits, for covered employees.

Note 11
Acquisition

On June 30, 1976, the Company acquired the outstanding capital stock of the principal U.S. subsidiaries of the Burmah Oil Company Limited for approximately $522 million in cash. The acquisition was financed initially by short-term borrowings, which were replaced by the sale of a $280 million nonrecourse production payment in September 1976, $100 million in promissory notes issued in October 1976, and with proceeds received from $150 million in 8% Sinking Fund Debentures issued in April 1977. (The Company subsequently repurchased the approximate $200 million balance of the production payment in September 1977.) The consolidated operating results of the Company include the operations of the acquired companies from the date of acquisition.

Shown below are the unaudited combined results of operations for the year ended December 31, 1976, assuming that the acquisition had taken place on January 1, 1976:

	(Dollars in Millions Except Per Share Statistics)
Net sales and revenues	$6,005.5
Net earnings	345.2
Net earnings per common share:	
Primary	7.29
Fully diluted	6.73

The effects of the above acquisition on the Consolidated Statement of Changes in Financial Position for the year ended December 31, 1976, are shown in the following table:

	(Dollars in Millions)
Acquisition:	
Property, plant and equipment	$627.1
Other assets	138.2
Liabilities assumed	(243.6)
Total cost of acquisition	521.7
Less working capital at date of acquisition	26.6
Net increase in long-term assets	$495.1

Note 12
Quarterly Results of Operations (Unaudited)

The following is a summary of the unaudited quarterly results of operations for the years ended December 31, 1977 and 1976:

	(Dollars in Millions Except Per Share Statistics)			
	First	Second	Third	Fourth*
1977				
Net sales and revenues	**$1,551.3**	**$1,667.4**	**$1,623.1**	**$1,521.3**
Earnings from operations	**195.9**	**222.5**	**219.6**	**176.0**
Net earnings	**88.1**	**100.0**	**103.5**	**131.9**
Net earnings per common share:				
Primary	**1.84**	**2.05**	**2.12**	**2.71**
Fully diluted	**1.71**	**1.94**	**2.00**	**2.55**
1976				
Net sales and revenues	$1,305.5	$1,363.6	$1,497.4	$1,587.1
Earnings from operations	166.7	194.4	213.8	204.7
Net earnings	75.6	95.6	91.8	90.2
Net earnings per common share:				
Primary	1.60	2.03	1.94	1.90
Fully diluted	1.48	1.87	1.80	1.74

*Included in the Company's results in the fourth quarter of 1977 is a nonrecurring gain of $55.1 million, or $1.07 per fully diluted common share (see Note 6). Fourth quarter 1977 results were adversely affected by a two-month International Longshoremen's Association strike.

Note 13
Replacement Costs (Unaudited)

Replacing existing items of property, plant and equipment with assets having equivalent productive capacity would require a substantially greater capital investment than was required at the time these assets were originally purchased, reflecting principally the cumulative effect of inflation over the relatively long lives of these assets.

The Company's production costs have risen because of increases in the general level of prices. If the Company's cost of products sold and operating expenses were recast to reflect replacement costs, reported gross margins would be reduced. Excluding the effects of replacement cost depreciation and amortization, the historical cost of products sold and operating expenses generally reflect replacement costs since most of the Company's inventory is valued by the last-in, first-out (LIFO) method which tends to match current costs with sales and revenues at the time of sale. Historically, the Company has endeavored to compensate for cost increases by modifying its selling prices and increasing operating efficiency, although competitive and regulatory conditions can limit the Company's ability to increase selling prices.

The Company's Annual Report to the Securities and Exchange Commission on Form 10-K (a copy of which is available upon request) contains specific information with respect to the estimated replacement cost of inventories and property, plant and equipment at December 31, 1977 and 1976, and the estimated effect of such costs on depreciation and amortization expense and cost of products sold and operating expenses for the years ended December 31, 1977 and 1976.

Report of Ernst & Ernst Independent Auditors

R.J.Reynolds Industries, Inc.
Its Directors and Stockholders

We have examined the consolidated balance sheets of R.J. Reynolds Industries, Inc. and subsidiaries as of December 31, 1977 and 1976, and the related consolidated statements of earnings and earnings retained and changes in financial position for the years then ended. Our examinations were made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In our report dated February 17, 1977, our opinion on the 1976 financial statements was qualified as being subject to the effect on the 1976 financial statements of such adjustments, if any, as might have been required had the outcome of three civil actions, purporting to be class actions, been known. As explained in Note 7, counsel has advised the Company that in its opinion none of the civil actions is a proper class action, in which event none of the civil actions should result in any material liability. Accordingly, we have removed our qualification on the 1976 financial statements.

In our opinion, the financial statements referred to above present fairly the consolidated financial position of R.J. Reynolds Industries, Inc. and subsidiaries at December 31, 1977 and 1976, and the consolidated results of their operations and the changes in their consolidated financial position for the years then ended, in conformity with generally accepted accounting principles applied on a consistent basis.

Ernst & Ernst

E&E

Winston-Salem, North Carolina
February 16, 1978

R.J.Reynolds Industries, Inc.

Lines of Business Data

(Dollars in Millions)

	1977	1976
For the Years Ended December 31		
Net Sales and Revenues		
Domestic tobacco	**$2,854.9**	$2,659.9
International tobacco	**1,262.5**	1,111.2
Transportation	**872.8**	862.2
Energy	**978.9**	741.8
Foods and beverages	**268.7**	264.5
Aluminum products and packaging-outside	**125.6**	114.4
-intersegment	**66.5**	61.5
Other (principally intersegment eliminations)	**(66.8)**	(61.9)
Consolidated net sales and revenues	**$6,363.1**	$5,753.6
Earnings from Operations		
Domestic tobacco	**$ 617.9**	$ 555.9
International tobacco	**82.4**	53.8
Transportation	**88.9**	123.2
Energy	**14.6**	36.2
Foods and beverages	**22.0**	20.5
Aluminum products and packaging	**17.4**	13.8
Other (principally corporate expense)	**(29.2)**	(23.8)
Consolidated earnings from operations	**$ 814.0**	$ 779.6

In the table above, sales and revenues by line of business include both sales and revenues to unaffiliated customers and intersegment sales, which are accounted for at prices comparable to normal, unaffiliated-customer sales. Earnings from operations are earnings before interest and debt expense, other income and expense (mainly items of a financial nature), foreign currency gains (losses), general corporate expenses, nonrecurring gains (losses) and the provision for income taxes.

R.J.Reynolds Industries, Inc.

Lines of Business Data

(Dollars in Millions)

	1977	1976
For the Years Ended December 31		
Depreciation, Depletion and Amortization Expense		
Domestic tobacco	**$ 32.7**	$ 27.9
International tobacco	**20.7**	13.8
Transportation	**83.9**	80.9
Energy	**75.9**	44.7
Foods and beverages	**3.7**	3.6
Aluminum products and packaging	**4.4**	3.7
Corporate	**1.9**	0.6
Consolidated depreciation, depletion and amortization expense	**$ 223.2**	$ 175.2
Capital Expenditures		
Domestic tobacco	**$ 50.9**	$ 59.7
International tobacco	**17.8**	23.1
Transportation	**77.0**	39.7
Energy	**101.6**	62.4
Foods and beverages	**2.9**	7.1
Aluminum products and packaging	**5.3**	10.8
Corporate	**29.1**	18.9
Consolidated capital expenditures	**$ 284.6**	$ 221.7
At December 31		
Assets		
Domestic tobacco	**$1,233.0**	$1,248.3
International tobacco	**595.5**	562.1
Transportation	**1,134.1**	1,130.2
Energy	**883.8**	891.9
Foods and beverages	**153.7**	146.1
Aluminum products and packaging	**93.1**	90.7
Corporate	**240.8**	220.3
Consolidated assets	**$4,334.0**	$4,289.6

Identifiable assets include both assets directly identified with the specific line of business and an allocable share of jointly used assets. All cash and security investments are included in corporate assets.

The Financial Review includes a description of the various lines of business.

Geographic Data

(Dollars in Millions)

	1977	1976
For the Years Ended December 31		
Net Sales and Revenues		
United States(1)	**$4,031.4**	$3,477.3
International transportation(2)	**872.8**	862.2
Canada	**335.2**	326.8
Europe	**506.7**	411.6
Other Geographic Areas	**617.0**	675.7
Consolidated net sales and revenues	**$6,363.1**	$5,753.6
Earnings from Operations		
United States	**$ 733.3**	$ 636.9
International transportation(2)	**88.9**	123.2
Canada	**16.2**	16.7
Europe	**13.4**	5.2
Other Geographic Areas	**(8.6)**	20.9
Other (principally corporate expense)	**(29.2)**	(23.3)
Consolidated earnings from operations	**$ 814.0**	$ 779.6
At December 31		
Assets		
United States	**$2,449.1**	$2,371.8
International transportation(2)	**1,134.1**	1,130.2
Canada	**171.7**	176.3
Europe	**221.4**	194.4
Other Geographic Areas	**116.9**	196.6
Corporate	**240.8**	220.3
Consolidated assets	**$4,334.0**	$4,289.6
Liabilities of the Company's operations located in foreign countries	**$ 313.7**	$ 380.2

Sales and revenues in the above table include only sales to unaffiliated customers (intercompany transfers between geographic areas are immaterial), and generally are shown geographically based on the location of the operating company making the sale. Identifiable assets are those assets of the Company that are identified with the sales attributed to each geographic area. All cash and security investments are included in corporate assets.

(1) Included in United States sales and revenues are export sales of $271 million in 1977 and $221 million in 1976. Substantially all of these amounts represent the sale of tobacco products to markets in the Middle East and Far East.

(2) Because of the nature of international trade, transportation assets, sales and earnings from operations have not been allocated to the various geographic areas. All of the Company's owned vessels are U.S.-flag ships. Transportation revenues classified geographically based on port-of-origin were as follows:

(Dollars in Millions)

	1977	1976
United States	**$ 421.1**	$ 469.5
Canada	**17.1**	10.7
Europe	**186.3**	155.8
Other Geographic Areas	**248.3**	226.2

Selected Five-Year Statistics

For the Years Ended December 31 *(Dollars in Millions Except Per Share Statistics)*

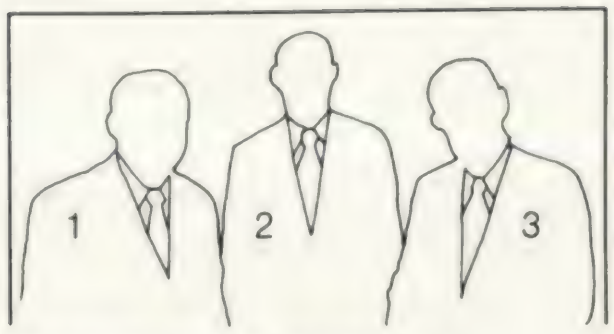
	1977	1976	1975	1974	1973
Total current assets	**$2,020.5**	$2,009.0	$1,697.4	$1,559.0	$1,146.2
Total current liabilities	**840.9**	980.3	714.4	737.1	428.5
Working capital	**$1,179.6**	$1,028.7	$ 983.0	$ 821.9	$ 717.7
Current assets/ current liabilities	**2.4**	2.0	2.4	2.1	2.7
Net property, plant and equipment	**$1,997.6**	$1,958.2	$1,264.6	$1,188.4	$1,171.4
Total assets	**4,334.0**	4,289.6	3,307.1	3,114.0	2,589.1
Return on average total assets (1)	**10.8%**	10.2%	11.4%	11.5%	10.8%
Long-term debt (including current maturities)	**$ 835.1**	$ 711.5	$ 489.9	$ 545.8	$ 580.2
Stockholders' equity	**2,391.7**	2,110.9	1,898.4	1,659.8	1,488.8
Total capital	**$3,226.8**	$2,822.4	$2,388.3	$2,205.6	$2,069.0
Return on average total capital (2)	**15.4%**	14.9%	15.9%	15.3%	13.9%
Total long-term debt as a percentage of total capital	**25.9%**	25.2%	20.5%	24.7%	28.0%
Capital expenditures	**$ 284.6**	$ 221.7	$ 196.7	$ 154.2	$ 315.4
Depreciation, depletion and amortization	**223.2**	175.2	131.8	116.9	86.9
Cash flow from operations	**722.1**	552.3	488.2	471.2	398.0
Dividends on Common and Preferred Stocks	**$ 166.7**	$ 153.9	$ 142.9	$ 131.0	$ 126.8
Dividends per common share	**3.335**	3.13	2.93	2.73	2.636
Dividend payout percentage (3)	**38.3%**	41.9%	40.2%	41.0%	48.3%
Common Stock price range:					
High	**70⅝**	68¼	61½	53⅜	55¾
Low	**58**	55	49½	37¼	36½
Net earnings as a percentage of net sales and revenues	**6.7%**	6.1%	7.0%	6.6%	7.5%
Return on average common stockholders' equity	**18.8%**	17.5%	19.0%	18.7%	17.0%
Book value per common share	**$ 48.97**	$ 44.55	$ 40.65	$ 37.40	$ 33.58
Number of stockholders at year-end	**113,827**	117,421	121,398	125,176	124,371
Number of employees at year-end	**36,705**	37,296	34,666	32,454	31,477

(1) Net earnings plus after-tax interest and debt expense divided by average total assets.

(2) Net earnings plus after-tax interest and debt expense divided by average total capital, excluding vessel construction loans. (Total capital is the sum of stockholders' equity and total long-term debt.)

(3) Total dividends on Common Stock as a percentage of net earnings applicable to Common Stock.

Board of Directors

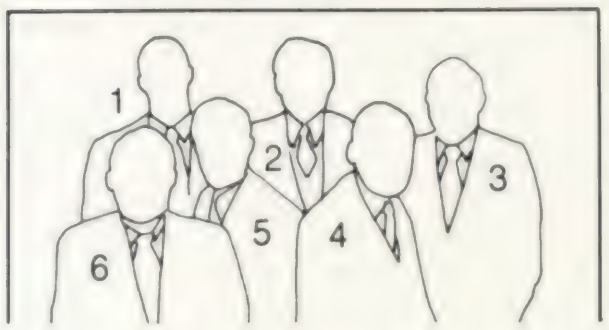


[1]HERSCHEL H. CUDD [a,c]
Former Senior Vice President
Standard Oil Company (Indiana)

[2]COLIN STOKES [c,e,f]
Chairman and Chief Executive Officer
R.J.Reynolds Industries, Inc.

[3]WALTER L. LINGLE, JR. [a,c,f]
Former Executive Vice President
The Procter & Gamble Company

On January 19, 1978, Margaret S. Wilson, chairman and chief executive officer of Scarbroughs Stores of Austin, Texas, was elected to the Board of Directors.



[1]JOHN D. MACOMBER [f]
Chairman and Chief Executive Officer
Celanese Corporation

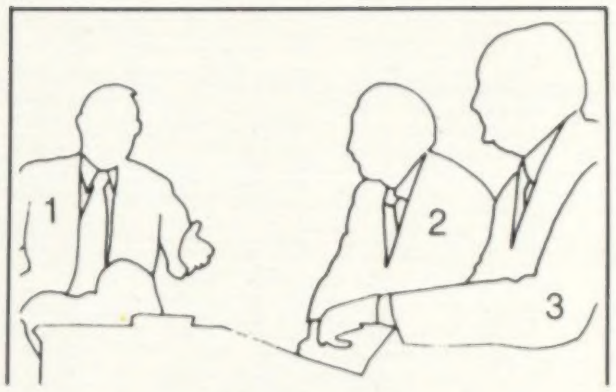
[2]WILLIAM S. ANDERSON [f]
Chairman and Chief Executive Officer
NCR Corporation

[3]C. F. BENBOW
Senior Vice President and Secretary
R.J.Reynolds Industries, Inc.

[4]J. TYLEE WILSON [e]
Executive Vice President
R.J.Reynolds Industries, Inc.
Chairman and Chief Executive Officer
R.J.Reynolds Tobacco
International, Inc.

[5]JOSEPH F. ABELY, JR. [e,f]
Executive Vice President and
Chief Financial Officer
R.J.Reynolds Industries, Inc.
Chairman, Finance Committee (RJR)

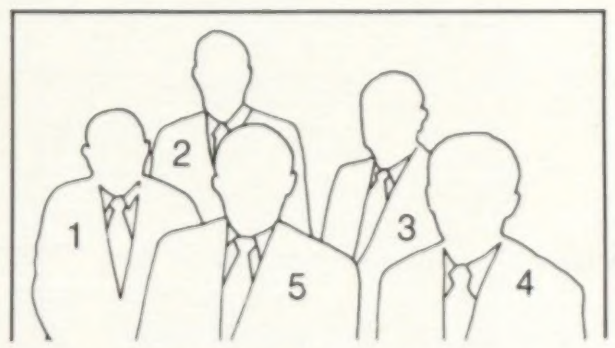
[6]WM. D. HOBBS [e]
Chairman and Chief Executive Officer
R.J.Reynolds Tobacco Company



[1]J. PAUL STICHT [c,e,f]
President and Chief Operating Officer
R.J.Reynolds Industries, Inc.
Chairman, Executive Committee (RJR)

[2]GORDON GRAY [a,c]
Chairman of the Board
Summit Communications, Inc.
Chairman, Compensation
Committee (RJR)

[3]ALBERT L. BUTLER, JR. [f]
President
The Arista Company



[1]JAMES R. PETERSON [e]
Executive Vice President
R.J.Reynolds Industries, Inc.

[2]J. DWAYNE TAYLOR
Executive Vice President
R.J.Reynolds Industries, Inc.

[3]CHARLES F. MYERS, JR. [a,c,f]
Retired Chairman of the Board
Burlington Industries, Inc.
Chairman, Audit Committee (RJR)

[4]H. C. ROEMER [e]
Vice President and General Counsel
R.J.Reynolds Industries, Inc.

[5]MICHAEL R. McEVOY
Executive Vice President
R.J.Reynolds Industries, Inc.

a. Audit Committee
c. Compensation Committee
e. Executive Committee
f. Finance Committee

Officers

COLIN STOKES
Chairman and Chief Executive Officer

J. PAUL STICHT
President and Chief Operating Officer

JOSEPH F. ABELY, JR.
Executive Vice President and
Chief Financial Officer

MICHAEL R. McEVOY
Executive Vice President

JAMES R. PETERSON
Executive Vice President

J. DWAYNE TAYLOR
Executive Vice President

J. TYLEE WILSON
Executive Vice President

C. F. BENBOW
Senior Vice President and Secretary

RODNEY E. AUSTIN
Vice President

DENNIS DURDEN
Vice President

E. C. RITCHELL
Vice President

H. C. ROEMER
Vice President and General Counsel

R. D. THOMPSON
Vice President

J. W. DOWDLE
Treasurer

J. A. HAGAN
Comptroller

Directors Emeriti

S. A. ANGOTTI
Retired Senior Vice President,
R.J.Reynolds Industries, Inc.

LEIGHTON H. COLEMAN
Former Partner,
Davis Polk & Wardwell

A. H. GALLOWAY
Retired Chairman,
R.J.Reynolds Industries, Inc.

WILLIAM R. LYBROOK
Retired Senior Vice President and Secretary,
R.J.Reynolds Industries, Inc.

H. H. RAMM
Retired Chairman of the Executive
Committee and Senior Vice President,
R.J.Reynolds Industries, Inc.

J. H. SHERRILL
Retired Vice President,
R.J.Reynolds Tobacco Company

R. G. VALLANDINGHAM
Retired Superintendent of Leaf Buying,
R.J.Reynolds Tobacco Company

JOHN C. WHITAKER
Retired Chairman,
R.J.Reynolds Tobacco Company

International Advisory Board

COLIN STOKES
Chairman,
R.J.Reynolds Industries, Inc.

J. PAUL STICHT
President,
R.J.Reynolds Industries, Inc.

HERMANN JOSEF ABS
Chairman, Supervisory Board,
Deutsche Bank A.G., Germany

CARLO BOMBIERI
Retired Managing Director,
Banca Commerciale Italiana
Italy

ARCHIE K. DAVIS
Retired Chairman, Wachovia Bank &
Trust Company, N.A.; former President,
American Bankers Association,
United States

CHUJIRO FUJINO
Chairman,
Mitsubishi Corporation, Japan

RONALD GRIERSON
Former Director General for
Industrial Affairs, EEC
Great Britain

ERLING S. LORENTZEN
President, Aracruz Celulose S.A. and of
the Lorentzen Group, Brazil

DONALD S. McGIVERIN
President, Hudson's Bay Company,
Canada

F. O. J. SICKINGHE
Chairman, Board of Management,
Verenigde Machinefabrieken N.V.,
Holland

PETER G. WILLIAMS
Chairman,
Inchcape (Hong Kong) Ltd.
Hong Kong

CHAS. B. WADE, JR.
Secretary

Transfer Agent, Registrar and Conversion Agent
MANUFACTURERS HANOVER TRUST COMPANY
Corporate Trust Division
4 New York Plaza
New York, New York 10015

Transfer Agent and Registrar
THE FIRST JERSEY NATIONAL BANK
2 Montgomery Street
Jersey City, New Jersey 07303

Dividend Reinvestment Agent
WACHOVIA BANK AND TRUST CO., N.A.
P.O. Box 3092
Winston-Salem, North Carolina 27102

Stockholder Inquiries
Communications concerning transfer requirements and lost certificates should be directed to either Transfer Agent. Communications concerning dividends and change of address should be directed to R.J. Reynolds Industries, Inc., Shareholder Services Department, Box 2959, Winston-Salem, North Carolina 27102.

Common and Preferred Shares
Listed on the New York Stock Exchange (trading symbol: RJR).

Corporate Headquarters
RJR World Headquarters
Reynolds Boulevard
Winston-Salem, North Carolina
Telephone: (919) 748-4000

Notice of Annual Meeting
The Annual Meeting of the Company's stockholders will be held in the Grand Promenade Ballroom of the Houston Marriott Hotel — West Loop, 1750 West Loop South, Houston, Texas, at 2 p.m. on Wednesday, April 26, 1978. A formal notice of the Annual Meeting, together with Proxy Statement and Proxy, will be mailed in March to stockholders of record at the close of business February 28, 1978.

Availability of Form 10-K
On or after March 31, 1978, a copy of the Company's Annual Report to the Securities and Exchange Commission on Form 10-K for the year ended December 31, 1977, will be provided to stockholders upon written request to the Secretary, R.J. Reynolds Industries, Inc., Winston-Salem, North Carolina 27102.

RJR

R.J.Reynolds Industries, Inc.
Winston-Salem, N.C. 27102